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Tax Information on S Corporations

For use in preparing
1990 Returns

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Introduction

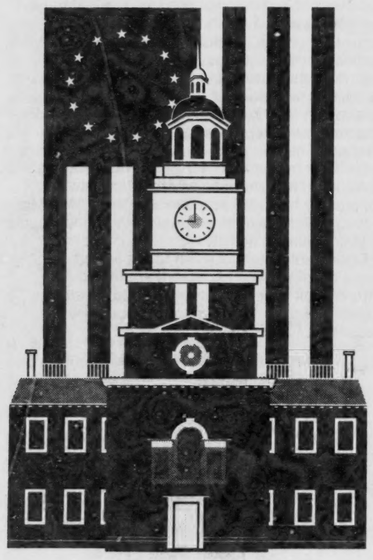
A corporation is taxed on its income under corporate tax rules. When it distributes dividends to its shareholders, the shareholders include these already taxed amounts in their income. In effect, corporate income is taxed twice, once to the corporation and again to the shareholders.

However, an eligible domestic corporation can avoid double taxation by electing to be treated as an S corporation under the rules of Subchapter S of the Internal Revenue Code. In this way, the S corporation passes its items of income, loss, deduction, and credits through to its shareholders to be included on their separate returns. Individual shareholders may benefit from a reduction in their taxable income during the first years of the corporation's existence when it may be operating at a loss.

Only qualifying corporations may elect S corporation status.

This publication discusses how to become an S corporation, how an S corporation may be taxed, how income is distributed to shareholders, and how to terminate an S corporation.

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call our toll-free telephone number 1–800–TAX–FORM (1–800–829–3676), or write the IRS Forms Distribution Center for your area as shown in the income tax package.



Becoming an S Corporation

A corporation can become an S corporation if:

1) It meets the requirements of S corporation status.
2) All its shareholders consent to S corporation status.
3) It uses a permitted tax year, or elects to use a tax year other than a permitted tax year, explained later.
4) It files Form 2553, *Election by a Small Business Corporation,* to indicate it chooses S corporation status.

Requirements of an S Corporation

To qualify for S corporation status, a corporation must meet all the following requirements:

1) It must be a domestic corporation. It must be a corporation that is either organized in the United States or organized under federal or state law. The term "corporation" includes a joint-stock company, certain insurance companies, or an association that has the characteristics of a corporation.
2) It must have only one class of stock. See *One class of stock,* later.
3) It must have no more than 35 shareholders. See *Counting shareholders,* later.
4) It must have as shareholders only individuals, estates (including estates of individuals in bankruptcy), and certain trusts. See *Trusts,* later. Partnerships and corporations cannot be shareholders in an S corporation.
5) It must have shareholders who are citizens or residents of the United States. Nonresident aliens cannot be shareholders.

Certain domestic corporations ineligible. Certain domestic corporations are ineligible to elect S corporation status. They are:

1) A member of an affiliated group of corporations. Generally, an affiliated group means one or more chains of corporations connected through stock ownership with a common parent corporation that is also part of the group. The common parent must directly own stock that possesses at least 80% of the total voting power of the stock of at least one of the corporations, and the stock must have a value equal to at least 80% of the total value of the stock of that corporation. Stock does not include certain preferred stock. A corporation is a member of an affiliated group if it directly owns 80% or more of the total combined voting power of stock entitled to vote and 80% or more of the total value of all other stock, except preferred stock, of another corporation. See *Subsidiaries,* later, for exceptions to this rule.
2) A ***DISC*** (Domestic International Sales Corporation) or former DISC.
3) A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession.
4) A financial institution that is a bank, including mutual savings banks, cooperative banks, and domestic building and loan associations.
5) An insurance company taxed under Subchapter L of the Internal Revenue Code.

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One class of stock. One class of stock generally means that the outstanding shares of the corporation must be identical as to the rights of the holders in the profits and in the assets of the corporation. Stock may have differences in voting rights and still be considered one class of stock.

A stock purchase agreement executed between an S corporation and its shareholders that does not affect the shareholders' rights in the corporation's profits and assets will not create a second class of stock.

Debt obligations of a corporation that are actually contributions of equity capital may be treated as a second class of stock. However, straight debt will not be considered a second class of stock.

The term "straight debt" means any written unconditional promise to pay a fixed amount on demand or on a specific date if:

1) The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors,
2) The debt cannot be converted directly or indirectly into stock, and
3) The creditor is an individual, estate, or trust eligible to hold stock in an S corporation.

Unissued stock. Authorized but unissued stock and treasury stock are not considered in determining if a corporation has more than one class of stock. Nor is special stock issued to the Federal Housing Administration considered when making this determination. The existence of outstanding options, warrants to acquire stock, or convertible debentures will not, by itself, be considered a second class of stock.

Counting shareholders. An S corporation cannot have more than 35 shareholders. When counting shareholders, the following rules apply:

1) Count the persons who are considered shareholders if the stock is actually held by a trust. (See *Trusts*, below.) Do not count the trust itself as a shareholder.
2) Count a husband and wife, and their estates, as one shareholder, even if they own stock separately.
3) Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

Trusts. The following trusts, other than foreign trusts, can be shareholders of an S corporation:

1) A trust all of which is treated as owned by an individual who is a United States citizen or resident. The individual, not the trust, is treated as the shareholder.
2) A trust that qualified under (1) before the owner's death, and continues in existence after the owner's death, may continue to be an S corporation shareholder for stock held by the trust when the owner died, but only for a period no longer than 60 days, beginning on the day of the owner's death. However, if the entire corpus of the trust is included in the owner's gross estate, the 60–day period becomes a 2–year period. The owner's estate is treated as the shareholder.
3) A trust created primarily to exercise the voting power of stock transferred to it. Each beneficiary of the trust is treated as a shareholder.
4) Any trust to which stock is transferred according to the terms of a will, but only for 60 days, beginning with the day the stock was transferred to the trust under the will. The estate of the person leaving the will is treated as the shareholder.

Qualified subchapter S trusts. In addition, the beneficiaries of certain other trusts can elect to have their trusts qualify as a trust described in (1), above. These trusts are known as "qualified subchapter S trusts." A qualified subchapter S trust is a trust described in section 1361(d) of the Code.

Subsidiaries. Generally, an S corporation cannot have a subsidiary that would cause it to be a member of an affiliated group of corporations. However, this rule may not apply if the subsidiary is inactive, a former DISC, or a foreign corporation.

Inactive subsidiary. An inactive subsidiary is one that, during any period in a tax year:

1) Has not begun business at any time on or before the close of that period, and
2) Does not have gross income for that period.

Former DISC or foreign corporation as a subsidiary. A corporation that holds a foreign corporation or former DISC as a subsidiary is not eligible to be an S corporation unless it qualified under the "grandfather rules" of the Subchapter S Revision Act of 1982.

Shareholder Consents

The corporation's election of S corporation status is valid only if all shareholders consent to the election. A shareholder's consent is binding and may be withdrawn only as explained later under *Revoking S Corporation Status.*

Form of consent. Shareholders may consent by providing the required information on Form 2553, *Election by a Small Business Corporation,* and signing in the appropriate space.

All shareholders must consent at the time Form 2553 is filed. If the consent is filed after the beginning of the year for which it is to be effective, all shareholders in the corporation who held stock on any day in the tax year before the date Form 2553 is filed must also consent.

An election made during the first 2 1/2 months of the tax year is considered made for the following tax year if one or more of the persons who held stock in the corporation during the tax year and before the election was made did not consent to the election.

The shareholder may also consent by signing a separate consent statement, which should be attached to Form 2553. The separate consent should provide the following information:

1) The name, address, and identification number of the corporation.
2) The name, address, and identification number of the shareholder.
3) The number of shares of stock owned by the shareholder and the date or dates acquired.
4) The day and month of the end of each shareholder's tax year.

The consents of all shareholders may be included in one statement. The corporation's election of S corporation status is invalid if any consent is not filed on time. However, if the corporation's election would be valid except for the failure of a shareholder to file a consent on time, that shareholder may apply for an extension of time to file the consent. The request for an extension of time to file should be sent to the Internal Revenue Service Center where Form 2553 was filed.

The time for filing a consent may be extended if:

1) It is shown to IRS's satisfaction that there was reasonable cause for the failure to file the consent and that the government's interest will not be jeopardized by treating the election of S corporation status as valid,
2) The shareholder who did not file a proper consent files the proper consent within the extended time granted by the IRS, and
3) All shareholders file new consents within the extended time. ***All*** shareholders include any one shareholder during the period for which the extension is granted.

Who must consent. Generally, each person who is a shareholder at the time the election is made must consent. If the election is made during the corporation's first tax year in which the S corporation status is effective, each person who was a shareholder at any time during the part of the tax year before the election is made must also consent to S corporation status for the corporation.

Co-owners. Each co-owner, tenant by the entirety, tenant in common, and joint tenant must consent. If stock is owned as community property or if income from the stock is community property, both husband and wife must consent.

Minors. The consent of a minor must be made by the minor or his or her legal representative (or a natural or an adoptive parent of the minor if no legal representative has been appointed).

Estates. The consent of an estate holding stock in an S corporation must be made by an executor or administrator of the estate.

Trusts. The consent of a qualified trust holding stock in a newly electing S corporation must be made by each person who is treated as a shareholder to determine whether the corporation meets the S corporation requirements. See *Trusts,* earlier, under *Requirements of an S Corporation.*

Tax Year

A ***permitted tax year*** is a calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS. In addition, an S corporation may elect under section 444 to have a tax year other than the permitted tax year.

A corporation electing S corporation status does not need IRS approval to choose a calendar year as its tax year. An electing S corporation should use Form 2553 to request a tax year other than a calendar year, or to make the section 444 election.

Substantial business purpose. A substantial business purpose exists if the corporation's requested year is a natural business year, or if the requested year satisfies an ownership tax year test. Both the natural business year and the ownership tax year tests are discussed in Publication 538. If neither of these apply, the corporation can establish a business purpose as discussed next.

Both tax factors and nontax factors must be considered to determine whether you have a substantial business purpose. A nontax factor for a substantial business purpose is the annual cycle of your business activity.

Significant weight is given to tax factors. A prime consideration in permitting the use of a different tax year is whether it would create a substantial distortion of income. Examples of distortion of income are:

1) Deferring a substantial portion of income, or shifting a substantial portion of deductions, from one year to another so as to reduce tax liability,
2) Causing a similar deferral or shifting for any other person, such as a shareholder, and
3) Creating a short period in which there is a substantial net operating loss.

For more information, see Publication 538.

Change of tax year. An S corporation should file ***Form 1128,*** *Application to Adopt, Change, or Retain a Tax Year,* to apply for permission to change its tax year to a year other than a year ending December 31. This form should be filed by the 15th day of the second calendar month after the close of the short tax year. This short tax year begins on the first day after the end of the corporation's present tax year and ends on the day before the opening date of its new tax year.

User fee. The corporation must submit a user fee of $200 with Form 1128. Form 1128 and the user fee should be filed with:

The Commissioner of Internal Revenue
Attention: CC: CORP
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20044

The package should be marked "Ruling Request Submission."

The application should contain all the requested information. It should show that there is a business purpose for the change. The deferral of income to shareholders generally will not be treated as a business purpose.

Note. Form 1128 should not be used to request a tax year for or during the first year the corporation elects to be an S corporation.

Section 444 election. S corporations may elect to use a tax year that is different from the permitted tax year. Certain restrictions apply to this election. For details on section 444 elections, see Publication 538.

Making the election. Unless you are a corporation electing S corporation status, make the section 444 election by filing ***Form 8716,*** *Election To Have a Tax Year Other Than a Required Tax Year,* with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The 15th day of the 5th month following the month that includes the first day of the tax year for which the election will first be effective, or
2) The due date, without extensions, of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1120S, *U.S. Income Tax Return for an S Corporation,* for the first tax year for which the election is made.

Required payment for S corporations. S corporations generally must make a required payment for any tax year that the section 444 election is in effect and the required payment amount is more than $500 for the tax year or any previous tax year. ***Form 8752,*** *Required Payment or Refund Under Section 7519,* is used to figure the required payment or refund. For election years beginning in 1990, Form 8752 must be filed and any required payment made by May 15, 1991.

For more information on the required payment, see the instructions for Form 8752.

Form 2553—Electing S Corporation Status

To be treated as an S corporation, a corporation must file Form 2553 to indicate its election of S corporation status. The corporation must qualify as an S corporation when it files its Form 2553. The Form 2553 should also be used to file shareholder consents and to select a tax year.

Form 2553 should be filed with the Internal Revenue Service Center where the S corporation will file its income tax return.

When to file Form 2553. The election of S corporation status is effective for a tax year if Form 2553 is filed:

1) Any time during the previous tax year, or
2) By the 15th day of the 3rd month of the tax year to which the election is to apply.

S Corporation Income and Expenses

Because the shareholders of an S corporation, rather than the S corporation, are taxed on its income, and some income and expense items are subject to special rules, it is necessary to divide the items of income, loss, expense, and credit of the S corporation into two categories. One category consists of items that are separately stated items, subject to special rules. The other category consists of combined items, resulting in a net amount. Both categories are discussed next under *Figuring S Corporation Income and Expenses.*

Figuring S Corporation Income and Expenses

To figure S corporation income, divide the S corporation's items of income, loss, expense, and credit into two categories:

1) Separately stated items, and
2) Items used to figure nonseparately stated income or loss.

The separately stated items and the nonseparately stated income or loss are collectively known as passthrough items because they are passed through to the shareholders on a pro rata basis. However, before they are passed through, some items may be reduced, as explained later under *Reducing passthroughs.*

Separately stated items. The items of income, loss, expense, and credit that must be separately stated are those items that, when separately treated on the shareholder's income tax return (not as part of a lump-sum amount) could affect the shareholder's tax liability.

The list of items that must be separately stated includes, but is not limited to:

1) Net income or loss from rental real estate activity
2) Net income or loss from other rental activity
3) Portfolio income or loss
   - Interest income
   - Dividend income
   - Royalty income
   - Short-term capital gain or loss
   - Long-term capital gain or loss
4) Section 1231 net gain or loss
5) Charitable contributions
6) Health insurance premiums
7) Section 179 expense deduction
8) Expenses related to portfolio income or loss
9) Credits
   - Low-income housing credit
   - Qualified rehabilitation expenses
   - Other credits
10) Investment interest expense
11) Tax preference and adjustment items needed to figure shareholders' alternative minimum tax.

Note. The indirect deduction through an S corporation of amounts that are not allowable as a deduction if paid or incurred directly by an individual is not allowed. For example, an individual cannot avoid the 2% floor on miscellaneous itemized deductions or the limits on personal interest by allowing an S corporation in which he or she is a shareholder to pay and deduct these amounts.

Interest expense. If an S corporation distributed borrowed funds to a shareholder, the corporation should separately state the interest expense on these funds and list as "Interest expense allocated to debt-financed distributions" under other deductions on the shareholder's Schedule K–1, discussed later. The shareholder deducts this interest on his or her tax return depending on how the shareholder uses the funds. See *Partnerships and S Corporations* in Publication 545, *Interest Expense.*

Nonseparately stated income or loss. Nonseparately stated income or loss is the net income or loss (gross income minus allowable deductions) of the corporation stated after excluding all the items that must be separately stated.

Tax preference items. If an S corporation (or any predecessor) was a regular corporation for any of the 3 immediately preceding tax years, the S corporation is required to adjust tax preference items. In determining its income or loss from operations for tax purposes, these items, which are also items subject to alternative minimum tax and are considered tax preference items, must be adjusted as follows:

1) ***Section 1250 capital gain treatment.*** For section 1250 property that is disposed of during the tax year, 20% of any excess of the amount that would be ordinary income if the property were section 1245 property, over the amount treated as ordinary income under section 1250, is treated as ordinary income under section 1250 and will be recognized. ***Section 1250 property*** includes all real property that is subject to an allowance for depreciation and that is not or has never been section 1245 property. ***Section 1245 property*** includes any property that is or has been subject to an allowance for depreciation and that is personal property (both tangible and intangible), and certain other property. See Publication 544, *Sales and Other Disposition of Assets,* for more information on these kinds of property.
2) ***Percentage depletion.*** For iron ore and coal (including lignite), the amount allowable as a percentage depletion deduction is reduced by 20% of any excess of the amount of the percentage depletion deduction allowable for the tax year (determined without this adjustment), over the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).
3) ***Pollution control facilities.*** The amortizable basis of pollution control facilities is reduced by 20% for purposes of determining the amortization deduction for that property.
4) ***Mineral exploration and development costs.*** The amount allowable as a deduction for mineral exploration and development costs is reduced by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the intangible drilling costs of an integrated oil company.
5) ***Bad debt deductions.*** Bad debt deductions for financial institutions must be reduced by 20%.

If an adjustment is made to a tax preference amount under the above rules, then an appropriate adjustment must be made to reduce the tax preference item for purposes of the alternative

minimum tax. See Publication 542, *Tax Information on Corporations*, for more information.

Corporate organizational expenses. An S corporation may elect to amortize corporate organizational costs over a period of not less than 60 months. See Publication 535, *Business Expenses*, for more information.

Reducing passthroughs. If the corporation is subject to the capital gains tax, the tax on built-in gains, or the tax on excess net passive income, discussed later under *S Corporation Taxes*, the related items are reduced in the following ways:

1) The amount of the corporation's long-term capital gain is reduced by any capital gains tax the corporation has to pay. If the amount of that tax exceeds the long-term capital gains, the excess is used to reduce the gain on the sale or exchange of section 1231 property. For this purpose, "long-term capital gain" does not include any gain from the sale or exchange of any section 1231 property.
2) The amount of each recognized built-in gain is reduced by its proportionate share of the tax the corporation has to pay on these gains.
3) The amount of each item of passive investment income is reduced by a portion of the tax on excess net passive income the corporation has to pay. Each item is reduced by an amount that has the same ratio to the tax on excess net passive income as each item of passive investment income has to the total passive investment income for the tax year.

Uniform capitalization rules. Certain costs incurred in connection with property produced or acquired for resale must be capitalized or included in inventory. These rules do not apply to personal property acquired for resale unless the corporation's average annual gross receipts for the 3 preceding tax years exceed $10 million. See Publication 538, *Accounting Periods and Methods*, for more information.

Choosing income tax treatment of an item. The S corporation makes all the elections that affect the computation of items it has to report on its return, except as noted below.

Exceptions. Each shareholder, rather than the S corporation, makes the following elections:

1) The elections on deduction and recapture of certain mining exploration costs. See Publication 535, *Business Expenses*, for more information.
2) The election on whether to deduct or claim a foreign tax credit on taxes the S corporation pays or accrues to foreign countries or U.S. possessions. See Publication 514, *Foreign Tax Credit for Individuals*.

Income from discharge of indebtedness. If the S corporation filed for bankruptcy, is insolvent, or the indebtedness discharged is qualified farm indebtedness, the debt is not included as income by the S corporation, but the tax attributes (net operating losses, general business credit carryovers, capital loss carryovers, basis in property, and foreign tax credit carryovers) are reduced by the amount of the discharged debt.

Carryovers and carrybacks. A corporation that becomes an S corporation generally cannot have carryovers or carrybacks from tax years when it was not an S corporation to years when it is an S corporation. See the tax on built-in gains, discussed later, for an exception to this general rule.

However, each year the corporation is an S corporation counts as a year for the purpose of determining the number of years to which an item may be carried back or carried forward.

Example. In its first tax year, a corporation had a net operating loss. In its second year, it elected to become an S corporation. It generally cannot use the net operating loss carryover in this second tax year or in any tax year during which the corporation remains an S corporation. Each year that the corporation is an S corporation counts as a year for purposes of figuring the 15–year carryover period for net operating losses. Therefore, if the corporation does not terminate its S corporation election before the end of the 15–year net operating loss carryover period, the net operating loss incurred in its first tax year, when no S corporation election was in effect, may not be used.

Limits for certain items. The limits for the following items are applied to both the S corporation and to the S corporation shareholder:

1) The $10,000 limit on the section 179 deduction. See Publication 534, *Depreciation*, for more information.
2) The $10,000 limit on reforestation costs. See Publication 535 for more information.

Limit on investment interest. If the S corporation borrows money to buy or carry investment property, interest expense from these debts must be identified and separately stated on Schedule K–1 (Form 1120S) for each shareholder. The shareholders are subject to a limit on the deduction of this interest expense. This interest expense does not include any amounts used in determining income or loss from a passive activity, nor does it include any interest expense allocable to a rental real estate activity.

Investment income and investment expenses other than interest must also be separately stated on Schedule K–1 (Form 1120S). See Publication 550, *Investment Income and Expenses*, for more information.

Disallowed losses. Losses realized on sales or exchanges of property between related taxpayers generally may not be deducted. If the related party acquiring the property in a transaction in which the loss is disallowed later resells the property at a gain, the gain is recognized only to the extent that it is more than the amount of the loss that is allocable to the property sold or otherwise disposed of by the taxpayer.

Related taxpayers. For purposes of the rule on disallowed losses, related taxpayers include the following:

1) Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test,
2) An individual and a corporation if more than 50% of the value of the outstanding stock is owned by the individual,
3) A trust fiduciary and a corporation if the trust or grantor of the trust owns more than 50% in value of the outstanding stock of the corporation,
4) The grantor and a fiduciary of any trust,
5) A fiduciary of a trust and a beneficiary of the trust,
6) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
7) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, and
8) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

Ownership of stock. In deciding whether a person owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
2) An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family,
3) Any individual owning, other than applying paragraph (2), any stock in a corporation is treated as owning the stock owned, directly or indirectly, by or for his or her partner, and
4) The family of an individual includes only his or her brothers and sisters (half-brothers or half-sisters), spouse, ancestors, and lineal descendants, and
5) Stock constructively owned by a person under paragraph (1), for applying paragraphs (1), (2), or (3), is treated as actually owned by that person. But stock constructively owned by an individual under paragraphs (2) or (3) is not treated as owned by him or her, for again applying either paragraph (2) or (3), to make another person the constructive owner of that stock.

Unpaid business expenses and interest. An accrual method S corporation must use the cash method for purposes of deducting business expenses and interest owed to cash method related parties. Therefore, an S corporation may not deduct business expenses or interest owed to a cash basis related party until the day payment is made and the amount is includible in the related party's gross income. This rule will apply even if the S corporation and the related person cease to be related before the expenses or interest are includible in the gross income of that person.

An accrual method S corporation's deduction for business expenses will depend on when economic performance occurs. The economic performance rule is discussed in Publication 538, *Accounting Periods and Methods*.

Special rules for S corporations. Related parties also include, in the case of any amount paid or incurred by, to, or on behalf of an S corporation:

1) An S corporation and a shareholder of the S corporation who owns, directly or indirectly, any of the stock of the S corporation,
2) An S corporation and any person who owns, directly or indirectly, any capital or profits interest of a partnership in which this S corporation owns, directly or indirectly, any capital or profits interest,
3) Any person related under the related party rules to a person described in (1) or (2). This rule applies to a transaction only if this transaction is related either to the operations of the partnership or to an interest in this partnership.

Distribution of appreciated property. An S corporation that distributes appreciated property will be treated as if it had sold the property to the distributee for fair market value. It will have to recognize any gain and pass that gain through to its shareholders. For an exception to this rule, see *Exception* under *Appreciated property distributions*, later.

The S corporation as a shareholder. For purposes of corporate tax provisions, if an S corporation is a shareholder in another corporation, the S corporation is treated as an individual. For example, if an S corporation receives a distribution of property based on the stock it holds, the tax consequences of the distribution are figured as if the S corporation is an individual and not a corporation.

S Corporation Taxes

The S corporation, like any other business, pays its own excise and employment taxes. See Publication 510, *Excise Taxes in 1991*, and Publication 937, *Business Reporting*. However, it is subject to income tax only in certain instances.

An S corporation may be subject to the following taxes:

1) The tax on excess net passive investment income,
2) The tax on certain capital gains,
3) The tax on built-in gains,
4) The tax from recomputing a prior-year investment credit,
5) Estimated tax payments, and
6) LIFO recapture tax.

If the corporation was incorporated and elected S corporation status before 1987, it generally need not be concerned with the tax on built-in gains.

Tax on Excess Net Passive Income

If an S corporation has pre-S corporation earnings and profits at the end of a tax year and its passive investment income, defined later, is more than 25% of its gross receipts, the S corporation may be subject to a tax on excess net passive income. If passive investment income is more than 25% of gross receipts for 3 consecutive tax years and the corporation has pre-S corporation earnings and profits at the end of each of those tax years, the corporation's S corporation status will be terminated. See *Violating the Passive Income Restriction*, later.

An S corporation will not be subject to the tax on excess net passive income if it has been an S corporation for each of its tax years.

Gross receipts. The term "gross receipts" means the total amount an S corporation receives or accrues under the method of accounting it uses to figure its taxable income. Therefore, gross receipts are not reduced by returns and allowances, cost of goods sold, or deductions. Gross receipts include the total amount received or accrued from the sale or exchange of any kind of property (except capital assets and stock or securities), from services rendered, or from investments. Only the capital gain net income from the sale or exchange of capital assets (other than stock or securities) and only the gains from the sale or exchange of stock or securities are included in gross receipts.

Gross receipts do not include amounts received from:

1) A loan,
2) Repayment of a loan,
3) Contributions to capital,
4) Issuing stock in the S corporation,
5) A nontaxable sale or exchange (except for sales and exchanges during a 12–month liquidation), except to the extent that gain is recognized by the S corporation, or
6) The deferred or unrecognized portion of any gain on sales or exchanges made from an installment sale, except for installment sales of stocks and securities.

Sales or exchanges of stock or securities. A sale or exchange of stock or securities is included in gross receipts only to the extent of the gain. Losses on sales or exchanges are not a part of gross receipts. Nor are they offset against gains on sales or exchanges when figuring gross receipts. Gross receipts from the sale or exchange of stock or securities include gains received for the sale or exchange by an S corporation, even though it is a regular dealer in stocks and securities.

Amounts received in exchange for stock in a corporate liquidation are not included in gross receipts if the S corporation owned more than 50% of each class of the liquidating corporation's stock on the date of the first distribution with respect to the liquidation. This 50% requirement applies to a class of stock whether or not the class of stock has voting rights. For this requirement, shares of stock of the liquidating corporation held by an S corporation shareholder are not treated as held by the S corporation.

Passive investment income. Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. The amount included in passive investment income for sales or exchanges of stock or securities for an S corporation that is not an "options dealer" or "commodities dealer" is figured, as explained above, under *Sales or exchanges of stock or securities*. If the S corporation is an "options dealer" or a "commodities dealer," any gains or losses from section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options) or from property related to such contracts are not included when the computations are made, as explained earlier, under *Sales or exchanges of stock or securities*.

Royalties. Royalties include mineral, oil, and gas royalties, and amounts the S corporation receives for the use of patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises, and other like property.

Rents. Rents are amounts the S corporation receives for the use of, or the right to use, its real or personal property. This includes any amounts that may be imputed under the rules relating to the amount to be included as rental income for certain deferred payments for the use of property or services. Rents do not include payments for the use or occupancy of property if significant services are also provided to the occupant. Examples of payments not treated as rents include payments for the use or occupancy of rooms or other quarters in hotels, boarding houses, apartment houses that provide hotel services, tourist homes, motor courts, or motels. Generally, significant services are considered provided to the occupant if they are primarily for the occupant's convenience and they are not usually or customarily provided in the rental of rooms or other space for occupancy only.

For example, providing maid service is considered significant service to the occupant. Heat and light, cleaning public entrances, exits, stairways and lobbies, collecting trash, etc., are not considered significant services. Payments for parking cars usually are not rents. Payments for warehousing of goods or the use of personal property are not rents if significant services are provided with the payments.

Interest. Interest is any amount received for the use of money, including tax-exempt interest and unstated interest. Unstated interest includes amounts imputed on notes or obligations received in installment sales, obligations issued for property, and below-market loans. See Publication 537, *Installment Sales*, and *Below-market interest rate loans*, later.

Figuring the tax on excess net passive income. An S corporation is liable for a tax at a rate of 34% on excess net passive income if its passive investment income is more than 25% of gross receipts, and if at the end of the tax year it has earnings and profits from any tax year in which the corporation was not an S corporation or subchapter S corporation.

Net passive income. Net passive income is passive investment income, described above, reduced by deductions directly connected with the production of passive investment income. This does not include net operating losses and dividends-received deductions allowed to corporations that are not S corporations.

Investment-related deductions allowable in figuring net passive income generally include brokerage fees, interest expenses, safe deposit box rentals, and investment advisory fees.

Excess net passive income. Excess net passive income for the tax year is the amount that has the same ratio to net passive income as the amount of passive investment income that exceeds 25% of gross receipts has to passive investment income. Therefore, to figure excess net passive income, multiply net passive income by a fraction consisting of passive investment income minus 25% of gross receipts over passive investment income.

Excess net passive income cannot be more than the S corporation's taxable income for the year. See *Figuring corporate taxable income*, later.

A worksheet is provided in the instructions for Form 1120S to figure the tax on excess net passive income.

Special rules. The only credit that can be used by the S corporation to offset this tax is the credit figured on Form 4136, *Computation of Credit for Federal Tax on Fuels*.

If any gain is used to figure both the tax on excess net passive income and the tax on capital gains, the amount of gain subject to the capital gains tax is reduced, as explained later under *Reducing corporate capital gains*. The amount of passive investment income for purposes of figuring the tax on excess passive income is determined by not taking into account any recognized built-in gain or loss of the corporation.

If the corporation is subject to the tax on excess net passive income, it must reduce the items of passive income passed through to the shareholders, as described earlier under *Reducing passthroughs*.

Waiver of tax on excess net passive income. The IRS may waive the tax on excess net passive income if the S corporation establishes to IRS's satisfaction that:

1) It determined in good faith that it had no pre-S corporation earnings and profits at the close of the tax year, and
2) During a reasonable period of time after it was determined that it did have such earnings and profits at the close of the tax year, the earnings and profits were distributed.

Capital Gains Tax

An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if:

1) Its net long-term capital gain exceeds its net short-term capital loss by more than $25,000,
2) The excess is more than 50% of the corporation's taxable income, and
3) The taxable income is more than $25,000.

If the S corporation is also liable for the tax on excess net passive income, it should figure that tax before it figures its capital gains tax.

If an S corporation has capital gains, before it can decide whether it is liable for the capital gains tax, it must:

1) Reduce its capital gains to the extent they are subject to the tax on excess net passive income.
2) Figure its taxable income.

Reducing corporate capital gains. If the S corporation is subject to the tax on excess net passive income, it must reduce its capital gains by the share of excess net passive income that is due to the capital gains. This reduced capital gain is the amount used to decide whether the corporation must pay a capital gains tax and how much is due.

Figuring corporate taxable income. Although an S corporation's taxable income is generally figured like a partnership's for filing a return, taxable income for the capital gains tax, the tax on built-in gains, discussed later, and the limit on excess net passive income, are figured, with certain modifications, as though the corporation is filing a corporate tax return.

Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed to a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividends-received deductions.

The easiest way to make this calculation is to use page 1 of Form 1120, *U.S. Corporation Income Tax Return*, lines 1 through 28. The amount on line 28 is the amount of taxable income.

Applying the capital gains tax. When the S corporation knows the amount of its capital gains (reduced if necessary, as explained above) and its taxable income, it can answer "yes" or "no" to the following questions and use its answers to decide if it is liable for the capital gains tax.

A. Is net capital gain (line 9, Schedule D) more than $25,000, and more than 50% of taxable income (see the instructions for line 13, Schedule D)? . . . . . ☐ Yes ☐ No

B. Is taxable income (see the instructions for line 13, Schedule D) more than $25,000? . . . . . ☐ Yes ☐ No

C. Has the corporation been other than an S corporation at any time during the 3 tax years just before this year, or since existence, if it has been in existence for less than 4 years? ☐ Yes ☐ No

D. If the answer to question C is "No," does any long-term capital gain (line 8, Schedule D) represent gain from property described in each of items 1, 2, and 3 that follow? . . . . ☐ Yes ☐ No

1) The property was acquired during the tax year or within 36 months before the beginning of the tax year,
2) The property was acquired, directly or indirectly, from a corporation that was not in existence as an S corporation during the tax year or within 36 months before the tax year up to the time of the acquisition, and
3) The property has a substituted basis to you. (A substituted basis is determined by reference to its basis in the hands of the transferor corporation.)

If the S corporation answers "yes" to A, B, and C or A, B, and D, the tax applies and Schedule D (Form 1120S) must be completed.

Amount of tax. If the capital gains tax applies, the amount of the tax is the lesser of:

1) 34% of the amount by which the excess of the net long-term capital gain over the net short-term capital loss exceeds $25,000, or
2) The tax that would have been charged on the corporation's taxable income if it were not an S corporation.

Limit for property with a substituted basis. If the capital gains tax applies only because the property has a substituted basis (Question D was answered "yes"), the tax cannot be more than 34% of the net capital gain (excess of net long-term capital gain over net short-term capital loss) that is due to the property with the substituted basis.

Special rules. The only credit that can be used to offset this tax is the credit for federal tax on fuels. The corporation's long-term capital gains for the tax year must be reduced, as explained earlier under *Reducing passthroughs*.

Tax on Built-In Gains

If an S corporation has a net recognized built-in gain for any tax year beginning in the recognition period, a tax is imposed on the income of the S corporation for that tax year. The ***recognition period*** is the 10-year period beginning with the first day of the first tax year the corporation was an S corporation.

The tax generally applies only to a corporation that converted from a regular corporation to an S corporation after 1986. It does not generally apply to any corporation if an election to be an S corporation was in effect for each of its tax years. An S corporation and any predecessor corporation are treated as one corporation for this purpose. However, see *Transfer of assets from a corporation to an S corporation*, later.

Net recognized built-in gain. Generally, the term "net recognized built-in gain" for any tax year in the recognition period is ***the lesser of:***

1) The amount that would be taxable income of an S corporation for the tax year if only recognized built-in gains and recognized built-in losses were taken into account, or
2) The amount that would be taxable income of the corporation if it were not an S corporation. Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividend-received deductions.

Carryover. If the amount in item (1) is more than the amount in item (2), the excess is treated as recognized built-in gain in the following tax year. The carryover provision does not apply to corporations that elected to be S corporations before March 31, 1988.

Recognized built-in gains. The term "recognized built-in gain" is any gain recognized on the disposition of any asset during the recognition period, except to the extent the S corporation shows that:

1) The asset was ***not*** held by the S corporation as of the beginning of its first tax year as an S corporation, or
2) The gain is more than the fair market value of the asset at the beginning of the first tax year minus the adjusted basis of the asset at the beginning of that year.

A recognized built-in gain also includes any item of income properly taken into account during the recognition period, but which is from periods before the first tax year the corporation was an S corporation. Therefore, disposing of an asset includes not only sales and exchanges, but also other income recognition events that give up a right to claim or receive income.

For example, the collection of accounts receivable by a cash method S corporation and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting are treated as dispositions of an asset.

First tax year. The first tax year a corporation is treated as an S corporation is determined by its most recent election to be an S corporation.

Recognized built-in loss. A recognized built-in loss is any loss recognized when any asset is disposed of during the recognition period, to the extent the S corporation shows that:

1) The asset was held by the S corporation at the beginning of the first year it was an S corporation, and
2) The loss is not more than:
   - The adjusted basis of the asset at the beginning of its first tax year as an S corporation, minus
   - The fair market value of the asset at the beginning of that year.

Deduction items. Any amount allowable as a deduction during the recognition period, but which came from periods before the first tax year the corporation was an S corporation, is treated as a recognized built-in loss for the tax year it was allowable as a deduction.

Amount of tax. Generally, the amount of tax is figured by applying the highest corporate rate of tax (34%) to the net recognized built-in gain of the S corporation for the tax year.

However, the amount of the net recognized built-in gain taken into account for any tax year cannot be more than:

1) The net unrealized built-in gain, minus
2) The net recognized built-in gain for previous tax years beginning in the recognition period.

The ***net unrealized built-in gain*** is:

1) The fair market value of the assets of an S corporation at the beginning of its first tax year when an election to be an S corporation is in effect, minus
2) The total adjusted basis of these assets at that time.

Adjustment to net unrealized built-in gain. The net unrealized built-in gain must be adjusted for amounts treated as recognized built-in gains or losses.

Credits. The only credits allowed against the tax on built-in gains are the gasoline and special fuels tax credit and any carryforward of the general business credit from a pre-S corporation year.

Net operating loss carryforwards from pre-S corporation tax year. Any net operating loss carryforward from a pre-S corporation tax year is allowed as a deduction against the net recognized built-in gain of the S corporation for the tax year. To determine the loss that may be carried to later years, the net recognized built-in gain is treated as taxable income. The same rules apply for a capital loss carryforward from a pre-S corporation tax year.

Treatment of certain property. If the adjusted basis of any asset is fully or partly determined by the adjusted basis of another asset held by the S corporation at the beginning of the first tax year in which it was an S corporation:

1) The asset is treated as held by the S corporation at the beginning of that first tax year, and
2) Recognized built-in gain or loss is determined by the fair market value and adjusted basis of the asset at the beginning of that first tax year.

Transfer of assets from a corporation to an S corporation. Generally, if an S corporation acquires an asset, and its basis in the asset is fully or partly determined by a regular corporation's basis in the asset, then a tax is imposed on any net recognized built-in gain from the asset for any tax year beginning in the recognition period.

However, when figuring the tax, the day the assets were acquired by the S corporation must be taken into account rather than the beginning of the first tax year the corporation was an S corporation.

Tax from Recomputing a Prior-Year Investment Credit

This tax may apply if the corporation claimed investment credit on a prior year's corporate income tax return before it became an S corporation. If the S corporation makes an early disposition of the property, the S corporation, and not its shareholders, will be liable for payment of the tax. The corporation must complete Form 4255, *Recapture of Investment Credit*, and include the amount of the recapture tax on line 22(c), page 1 of Form 1120S. Write the words "section 47 tax" on this line.

Estimated Tax Payments

If an S corporation's tax liability for net recognized built-in gain, excess net passive income, and recapture of investment credit total $500 or more, the S corporation must pay quarterly estimated tax payments.

Generally, the quarterly estimated tax payments must equal 25% of the required annual estimated tax. The annual estimated tax is the lesser of:

1) 90% of the tax shown on the return for the tax year (or, if no return is filed, 90% of the tax for that year), or
2) The sum of —
   - 90% of the investment credit recapture and the tax on net recognized built-in gain, (or the tax on certain capital gains) shown on the tax return for the tax year (or if no return is filed, 90% of these taxes for the year) and
   - 100% of any tax on excess net passive income shown on the corporation's return for the preceding tax year.

If the preceding tax year was less than 12 months, the amount of the required annual estimated tax must be determined under (1), above.

For more information, see the discussion on annualizing under *Estimated Income Tax* in Publication 542, *Tax Information on Corporations*.

Time and amount of deposits. If a corporation's estimated tax is $500 or more, its estimated tax payments must be deposited with an authorized financial institution or a Federal Reserve Bank. Each deposit must be accompanied by a federal tax deposit coupon and deposited according to the instructions in the coupon book (Form 8109).

The due date of deposits is determined according to the table below. An S corporation's estimated tax should be deposited on or before the 15th day of the following months of the corporation's tax year.

Required Payment	Month Due
1st	4th month
2nd	6th month
3rd	9th month
4th	12th month

A corporation that does not make a payment when it is due may be charged a penalty for the period of underpayment.

LIFO Recapture Tax

If a corporation made an election to be an S corporation after December 17, 1987, and used the LIFO inventory pricing method for its last tax year before its S election became effective, the corporation may be liable for LIFO recapture.

The LIFO recapture tax is figured for the pre-S corporation's last tax year. (See the instructions for Form 1120 or Form 1120A.) The LIFO tax is paid in four equal installments. The first installment is due with the corporation's Form 1120 or Form 1120A for the corporation's last tax year, and the three remaining deferral installments are paid with the corporation's Form 1120S for the next 3 tax years. Include each year's installment in the total amount to be entered on line 22c, page 1 of Form 1120S. Write to the left of the line 22c total the installment amount and the words "LIFO tax."

Filing Form 1120S

A domestic corporation must file Form 1120S, *U.S. Income Tax Return for an S Corporation*, if:

1) It elected to be taxed as an S corporation,
2) The IRS accepted the election, and
3) The election remains in effect.

Due date of return. If an S corporation's income tax return (Form 1120S) is made on a calendar year basis, the return must be filed by March 15 following the close of the tax year. If an S corporation is permitted to use a fiscal year as its tax year, its return must be filed by the 15th day of the 3rd month following the close of its fiscal year.

Saturday, Sunday, or holiday. If the last day (due date) for performing any act for tax purposes, such as filing a return or making a tax payment, falls on a Saturday, Sunday, or legal holiday, the corporation may act on the next day that is not a Saturday, Sunday, or legal holiday.

Place for filing. An S corporation files its Form 1120S with the Internal Revenue Service Center serving the area where the principal office for keeping the corporation's books and records is located. Service center locations are listed in the instructions to the forms.

Payment of tax. The corporation must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year.

Corporation income tax payments and estimated tax payments must be deposited with a Federal Tax Deposit Coupon (Form 8109). The tax deposits should be made with either a financial institution qualified as a Depositary for Federal Taxes or the Federal Reserve Bank or Branch serving the area where the corporation is located. Deposits should not be sent directly to an IRS office. Otherwise, the corporation may be subject to a 5% penalty. Records of deposits will be sent to the IRS for crediting to the corporation's account. See the instructions contained in the coupon book (Form 8109) for more information. There will no longer be periodic mailouts of Federal Tax Deposit forms. The reorder form (Form 8109A) provided in the coupon book should be used to get more deposit forms.

For more information on deposits, see Publication 583, *Information for Business Taxpayers*.

Late payment. Payments made after the due date are subject to an interest charge, even if filing extensions were granted. Payments of income tax made after the due date may also be subject to a penalty of 0.5% a month or part of a month up to a maximum of 25%.

Extension of time for filing. An S corporation will receive an automatic 6-month extension to file a return by submitting an application for extension on Form 7004. This form is filed with the Internal Revenue Service Center where the S corporation must file its income tax return. The IRS may terminate this extension at any time by mailing a termination notice to the corporation. Form 7004 must be filed by the due date of the S corporation's income tax return.

Any automatic extension of time for filing an S corporation's income tax return will not extend the time for payment of the tax due as shown on the return.

Interest. Interest is charged on the difference between the amount of tentative tax reported on Form 7004 and the amount of actual tax the corporation must pay when filing its income tax return.

Late filing. If an S corporation does not file its return by the due date, including extensions, and if it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for not more than one month. An additional 5% is imposed for each additional month or part of a month during which the delinquency continues. The penalty is limited to a total of 25%. The tax due is the tax liability that would be shown on a return minus credits and any tax payments made before the due date. The penalty for late filing is reduced by the late payment penalty.

If the return is not filed within 60 days after the due date, including extensions, the penalty for late filing will be at least $100 or the balance of tax due, whichever is less, unless reasonable cause is shown.

Reasonable cause. An S corporation that wishes to avoid a penalty for late filing or payment must be able to show reasonable cause. This should be done by filing with the Director of the Service Center where the return must be filed a statement of the facts establishing reasonable cause for failure to file a return or pay the tax on time. The statement must also contain a declaration that it has been made under the penalties of perjury.

Schedule K–1 (Form 1120S). An S corporation must furnish a copy of Schedule K–1, *Shareholder's Share of Income, Credits, Deductions, etc.*, or a substitute Schedule K–1, to each person or entity that was a shareholder during the year. Not furnishing this form or a substitute by the day Form 1120S was filed, or not including all the required information, or including incorrect information, may result in a $50 penalty for each form not furnished, incomplete, or incorrect. The total penalty, however, cannot be more than $100,000 for the calendar year. For information on the substitute Schedule K–1, see the instructions for Schedule K and Schedule K–1 (Form 1120S).

Criminal penalties. Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement.

Amended return. To correct an error on a Form 1120S already filed, the corporation should file a corrected Form 1120S and write "AMENDED" across the top. If the amended return results in a change to income, or a change in the distribution of any income or other information provided to shareholders, an amended Schedule K–1 (Form 1120S) must also be filed with the amended Form 1120S and given to each shareholder. "AMENDED" should be written across the top of the corrected Schedule K–1.

Figuring Shareholder Taxable Income

Each shareholder reports a pro rata share of each item of income, loss, deduction, or credit that is

separately stated and a pro rata share of nonseparately stated income or loss on his or her income tax return.

When it is reported on the shareholder's income tax return, the character of any item included in a shareholder's pro rata share is determined as if the item were realized directly from the source from which the S corporation realized it, or incurred in the same manner in which the corporation incurred it.

A shareholder's gross income is considered to include the shareholder's pro rata share of the gross income of the corporation.

Self-employment tax. A shareholder's share of the corporation's taxabie income is not self-employment income, even though it is included in gross income of the shareholder.

However, if a shareholder is an officer of the corporation and performs substantial services, he or she is considered an employee. Reasonable compensation for these services is subject to FICA, FUTA, and income tax withholding, no matter what the corporation calls the payments.

Optional 10–year write-off of certain tax preferences. Generally, shareholders (who are individuals) may elect to deduct ratably over 10 years the following qualified expenses incurred during the tax year:

Research and experimentation costs, and

Mining exploration and development costs.

Intangible drilling cost paid or incurred after 1989 may be deducted ratably over a 60–month period.

In addition, an S corporation shareholder may elect to deduct in equal installments over a 3–year period the cost of increasing the circulation of a newspaper, magazine, or periodical.

If one of these elections is made, the costs will not be considered a tax preference item and will not be used in figuring alternative minimum tax. The election is made at the shareholder level. Therefore, these expenses are not deductible by the S corporation. Instead, they are passed through to S corporation shareholders on Schedules K and K–1 (Form 1120S), line 10. Shareholders who do not make the election for the expenses passed through may incur tax preference items reportable on an *Alternative Minimum Tax* return.

These elections may be revoked only with the consent of the IRS. Each shareholder of an S corporation makes a separate election for his or her allocable share of any qualified expense.

A shareholder may elect to use the optional write-off by the due date, including extensions, of the return for the year the election is made. The election is made by attaching a statement to the shareholder's return or filing Form 4562, *Depreciation and Amortization*, with the shareholder's return. See Publication 909, *Alternative Minimum Tax*, for more information.

Noncash contributions. For all noncash contributions totaling more than $500, the S corporation must complete and attach Form 8283, *Noncash Charitable Contributions*, to its return. In addition, if the value of a contributed item or group of similar items is more than $5,000, the corporation must give a copy of its Form 8283 to each shareholder, even though the amount allocated to each shareholder is $5,000 or less.

Pro rata share. Except as explained later under *Terminating S Corporation Status*, each shareholder's pro rata share of each item to be entered on Schedules K and K–1 is figured on a per day, per share basis.

A pro rata share is figured as follows:

1) Divide the item by the number of days in the S corporation's tax year (to figure the daily amount of the item),
2) Multiply the daily amount of the item by the percentage of stock owned by the shareholder on that day (to figure the shareholder's daily part of the daily amount of the items), and
3) Total the shareholder's daily parts of the daily amount of the item (to figure the shareholder's pro rata share of the item for the tax year).

If there is no change in shareholders or in the percentage of stock each shareholder owns during the tax year, each shareholder's pro rata share of an item is the amount of the item times the percentage of stock owned by the shareholder during the year.

Limits on shareholder's losses and deductions. S corporation shareholders who hold stock at any time during the year claim their share of corporate losses and deductions, subject to certain limitations, on their individual tax returns.

Basis limit. The amount of losses and deductions a shareholder can take is limited to the adjusted basis of:

The shareholder's stock, plus

Any loans the shareholder makes to the corporation.

The adjusted basis of the shareholder's stock is figured at year end and includes the *Increases*, but not the *Decreases*, for that year listed later under *Adjustments to basis of shareholder's stock*. The adjusted basis of any loans is figured before any of the adjustments, discussed later under *Adjustments to basis of indebtedness*, are made for the tax year.

If the amount of the loss or deduction of a shareholder is limited, the excess is treated as incurred by the corporation in the next tax year for that shareholder and may be carried forward until used by that shareholder, unless limited by some other provision.

If the shareholder's losses or deductions are limited, as expiained above, for the last tax year the corporation is an S corporation, the excess is treated as incurred by the shareholder on the last day of the corporation's post-termination transition period. See *Post-termination transition period*, later. This excess amount cannot exceed the shareholder's adjusted basis of the stock in the corporation, determined at the close of the last day of the post-termination transition period. The losses or deductions taken into account during this period reduce the shareholder's basis in the stock of the corporation.

At-risk limit. At-risk rules may limit an S corporation shareholder's deductible loss from an activity conducted through an S corporation. These limitations apply at the shareholder level. An S corporation shareholder's amount at risk equals:

1) The shareholder's cash contributions and the adjusted basis of other property that the shareholder contributed to the S corporation, plus
2) Amounts borrowed for use in the activity that the shareholder is personally liable for the repayment of, or has pledged property not used in the activity as security for the borrowed amount.

To determine if the at-risk rules apply to an activity, the S corporation must identify each activity engaged in. Therefore, when the S corporation is involved in more than one activity, and one or more of the activities incurs a loss for the year, then each activity's profit and loss is figured separately. The S corporation should provide each shareholder with a schedule that reflects that shareholder's part of gross income and deductions for each activity.

Separate activities must be aggregated and treated as one activity if:

1) The shareholder actively participates in the management of the trade or business, or
2) 65% or more of the losses from the operations are allocated to persons who actively participate in the management of the trade or business.

In addition, all activities involving tangible personal property leased or held for lease must be treated as one activity.

The at-risk limitations do not apply to an activity of holding real property (other than mineral property) if the property was placed in service before 1987, and the shareholder acquired the interest in the S corporation before 1987. However, the limitations do apply to losses from an interest in an S corporation acquired after 1986, regardless of when the property used in the activity of holding real property was placed in service.

See Publication 925, *Passive Activity and At-Risk Rules*, for more information.

Limit on losses and credits from passive activities. The limitations on passive activity losses and credits may apply to losses and credits from an S corporation. These limits apply after the at-risk limits. Generally, a passive activity is any activity that involves the conduct of any trade or business in which the shareholder does not materially participate, or any rental activity. See Publication 925 and the *Instructions for Form 1120S, U.S. Income Tax Return for an S Corporation*, for information on how to report these activities to shareholders on Schedule K–1. Shareholders should see the *Shareholders Instructions for Schedule K–1 (Form 1120S)*.

Treatment of family groups. If a member of a family of shareholders in an S corporation renders service for the corporation or furnishes capital to the corporation without receiving reasonable compensation, the IRS can reallocate any items of income, deductions, etc., among shareholders who are members of the family to properly reflect the value of the services or capital. The family of any shareholder includes only the spouse, ancestors, and lineal descendants.

Adjustments to basis of shareholder's stock. During the time the corporation is an S corporation, each shareholder will increase or decrease the basis of his or her stock, but not below zero, as explained below.

Increases. Each shareholder's pro rata share of the following items increases the basis of the stock:

1) All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the shareholder,
2) Any nonseparately stated income of the S corporation, and
3) The amount of the deductions for depletion that is more than the basis of the property being depleted.

If an amount described in (1) or (2), above, is required to be included in income, a shareholder may increase the basis of the stock only by the amount actually included as gross income on his or her individual income tax return. This amount is increased or decreased by any adjustments in a redetermination of the shareholder's tax liability.

Decreases. Each shareholder's pro rata share of the following items decreases the basis of the stock:

1) Distributions by the S corporation that were not included in the shareholder's income (see *Distributions to Shareholders*, later, for more information),
2) All loss and deduction items of the S corporation that are separately stated and passed through to the shareholder,
3) Any nonseparately stated loss of the S corporation,
4) Any expense of the S corporation that is not deductible in figuring its income and not properly chargeable to a capital account, and
5) The shareholder's deduction for depletion of oil and gas property held by the S corporation to the extent it does not exceed the proportionate share of the adjusted basis of that property allocated to the shareholder.

Adjustments to basis of indebtedness. In certain cases, a shareholder may decrease the basis of any loans he or she made to the S corporation, and in later years restore the basis.

Reduction of basis. If for any tax year the amounts specified in items (2), (3), (4), and (5), above, under *Decreases*, exceed the amount required to reduce the shareholder's basis in stock to zero, the excess must be used to reduce, but not below zero, the shareholder's basis in any loans made to the S corporation.

Restoring basis. If the shareholder's basis in any loans made to the S corporation is reduced, as previously explained, any net increase for a later tax year, figured above under *Adjustments to basis of shareholder's stock*, should first be used to restore the basis of the loans and next to increase the basis of the stock.

Reduction of basis of loans. The shareholder's basis in a loan to an S corporation must be reduced by the amount his or her share of the items specified in (2), (3), (4), and (5), above, under *Decreases*, exceeds his or her basis in the S corporation's stock.

Loan repayments. If the shareholder's basis in the loan was reduced (and has not subsequently been completely restored), he or she will have income (other than interest) when the S corporation makes a payment on the loan. Each loan payment (other than interest) must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

To figure the amount of income to report from the loan payments, the shareholder should:

1) Figure the adjusted basis of the loan before payment.
2) Divide the adjusted basis in the loan by the outstanding loan balance.
3) Multiply the payment by the percentage from step (2). This amount is the part of the payment that will be a return of basis in the loan.
4) Take the difference between the amount of the payment and the amount from step (3). This is the amount that the shareholder must report as ordinary income.

The basis of the loan is reduced even if the shareholder has no tax benefit from the deduction for the basis reduction.

To figure the adjusted basis of the loan for a later payment, for a later restoration of basis, or for a later reduction of basis in the loan because of additional losses, the shareholder should subtract any amounts that are a return of basis from the adjusted basis of the loan.

Below-market interest rate loans. On certain loans an S corporation makes to employees or shareholders, the S corporation may be considered as having received interest income and having paid compensation or dividends equal to that interest. For more information, see Publication 535, *Business Expenses*.

Worthless stock and debt. If an S corporation's stock or loans to a shareholder become worthless during a tax year, the shareholder first adjusts the basis of his or her stock or debt by the shareholder's pro rata share of the corporation's items of income, deduction, etc., for that year.

After adjusting the basis of stock and loans, the shareholder must treat the worthless stock or registered loans as a loss from the sale or exchange of a capital asset. A worthless unregistered loan is treated as a short-term capital loss. For more information, see Publication 550, *Investment Income and Expenses*.

For example, if a shareholder has no basis in his or her S corporation stock, but has basis in debt owed by the corporation, and the debt becomes worthless, corporate losses for the year will first be passed through to the shareholder. These losses will reduce the shareholder's basis in the debt, which in turn will reduce the amount of the short-term capital loss for the worthless debt.

Depletion of oil and gas property. The cost or percentage depletion for oil and gas property is figured by each S corporation shareholder and not by the S corporation. The corporation gives to each shareholder a pro rata share of the basis of the oil or gas property at the later of:

1) The date the oil or gas property was acquired, or
2) The first day of the first tax year that begins after 1982 in which the corporation is an S corporation.

Shareholders must keep records of their share of the adjusted basis of each oil and gas property of the corporation, adjust their share of the adjusted basis for any depletion taken on the property, and use the adjusted basis each year to figure cost depletion or to figure gain or loss if the S corporation disposes of the property.

If the S corporation distributes the oil or gas property to its shareholders, the adjusted basis of the property is the sum of the shareholders' adjusted bases in the property.

Health insurance premiums. If you are a more than 2% shareholder in an S corporation, you are treated as self-employed for the purpose of contributing to a health insurance plan for yourself, your spouse, and dependents. You may deduct up to 25% of the amount paid on your behalf during the tax year for this health insurance. The deduction has been extended through tax years beginning before January 1, 1992.

Dollar limit. You may not deduct any amount that is more than the earned income (wages) you receive as an employee of the S corporation.

Medical deduction. Take the 25% deduction for health insurance premiums you paid on line 26, Form 1040. Do not include this amount with your other medical expenses when figuring your medical deduction on Schedule A, Form 1040. However, you may include the remainder of the premium in your medical expenses.

Other coverage. You may not take this deduction if you are eligible to participate in any subsidized health plan maintained by any employer of you or your spouse.

Note. The deduction for health insurance is not to be taken into account in determining an individual's net earnings from self-employment.

Shareholder's treatment of S corporation items. The tax treatment of any S corporation item is determined at the corporate level. Generally, a shareholder is required to treat S corporation items the same way on his or her tax return as they are treated on the S corporation return.

If an item on the shareholder's return is treated differently from the way it is treated on the S corporation return, the IRS can automatically assess taxes and penalties, and take action to immediately collect any deficiency and penalties that result from an adjustment to the shareholder's individual return to make that treatment consistent with the amount or treatment of the item on the S corporation return. However, this adjustment does not apply if the shareholder files Form 8082, *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR))*, with his or her return identifying the different treatment.

The shareholder need not file Form 8082 if a loss, other deduction, or investment credit shown on Schedule K–1 (Form 1120S) is not reported in full on his or her return solely because the shareholder is required to limit the item, such as under the at-risk rules.

These rules do not apply to an S corporation with five or fewer shareholders if each shareholder is a natural person or an estate (but not a passthrough shareholder), unless the corporation chooses to have them apply. There cannot be more than five shareholders at any time during the year. For S corporations, a husband and wife (and their estates) are treated as one shareholder. For stock owned by tenants in common or joint tenants, each individual is considered a shareholder.

Distributions to Shareholders

How S corporation distributions to a shareholder are taxed first depends on whether the corporation has earnings and profits.

An S corporation is not considered to have earnings and profits for tax years beginning after 1982 in which it was an S corporation. However, the corporation may have accumulated earnings and profits from years before 1983 or from tax years before an S corporation election was made. For more information, see *S Corporation with Earnings and Profits*, later.

Distributions from an S corporation that does not have any earnings and profits generally will be a nontaxable return of the shareholder's basis in the corporate stock. However, if the distributions are more than the shareholder's adjusted basis in the stock, the excess is taxable as a sale or exchange of property. See *S Corporation with No Earnings and Profits*, later.

If the S corporation has earnings and profits, the distributions may be taxable dividends, or they may be nontaxable or taxable as a sale or exchange of property. See *S Corporation with Earnings and Profits*.

A shareholder who receives a distribution from an S corporation must wait until the close of the corporation's tax year to be able to figure the tax treatment of the distribution.

The S corporation's distributions may be in the form of cash or property.

If the corporation distributes cash, the shareholder uses the amount received to figure the tax effect and the adjusted basis of his or her stock.

If property other than cash is distributed, the amount the shareholder uses as a distribution is the fair market value of the property.

Appreciated property distributions. If an S corporation distributes appreciated property, the S corporation will be treated as if it had sold the property to the shareholders at fair market value. Appreciated property is S corporation property that has a fair market value that is more than its adjusted basis to the S corporation.

The amount the shareholder uses as a value to figure the tax treatment of the property distribution is the same fair market value that the S corporation used when it treated the property as if it had been sold to the shareholder for fair market value.

S Corporation with No Earnings and Profits

If the S corporation has no earnings and profits, any distribution a shareholder receives is a return

of basis in the shareholder's stock in the S corporation, and, as such, it reduces the adjusted basis of his or her stock in the S corporation.

At the close of an S corporation's tax year, the shareholder must adjust his or her basis in the S corporation stock for all increases and decreases listed earlier under *Adjustments to basis of shareholder's stock.* This does not include the decrease to adjusted basis for any distributions during the S corporation's tax year.

The shareholder then uses this adjusted basis to figure the tax treatment of any distributions received during the S corporation's tax year.

If the distributions are ***less than or equal to*** the adjusted basis, they are a return of capital and the adjusted basis of the shareholder's stock after being reduced for the distributions is next year's beginning adjusted basis.

If the distributions are ***more than*** the adjusted basis of the shareholder's stock, the excess is a gain from the sale or exchange of property. As such, the gain is generally long- or short-term capital gain. The next year's beginning basis for shareholder's stock is zero.

Example. Acme, an S corporation, has no earnings and profits. Acme distributes $80,000 to its only shareholder, Betty. Her adjusted basis in the stock is $50,000. The amount of the distribution that exceeds her adjusted basis in the stock, $30,000 ($80,000 – $50,000), is taxable as a gain from the sale or exchange of property.

S Corporation with Earnings and Profits

The existence of earnings and profits is important to an S corporation if it has passive investment income or makes distributions. The presence of earnings and profits can mean that a distribution is a taxable dividend or the corporation is liable for a tax on its excess net passive income. See *Tax on Excess Net Passive Income,* earlier.

An S corporation is not considered to have earnings and profits for tax years beginning after 1982 in which it was an S corporation. However, an S corporation can have earnings and profits from:

1) Liquidations, redemptions, and reorganizations governed by the rules of Subchapter C of the Internal Revenue Code,
2) Tax years in which the corporation was not an S corporation,
3) Any of the S corporation's tax years that began before 1983, or
4) A corporate acquisition that results in a carryover of earnings and profits under section 381 of the Internal Revenue Code.

Earnings and profits can be reduced by an S corporation for payment of the tax from recomputing a prior-year investment credit. This reduction of earnings and profits may affect the tax treatment of distributions by an S corporation to its shareholders.

If an S corporation has earnings and profits, it may also have previously taxed income. In that case, a shareholder's treatment of a distribution is more complex than the treatment described earlier for S corporations with no earnings and profits. There is a general treatment for distributions of S corporations with earnings and profits and previously taxed income and another treatment for S corporations that elect, with the consent of their shareholders, to first distribute earnings and profits.

Retained earnings accounts. Retained earnings accounts contain any accumulated earnings and profits (E&P) of the corporation. If the corporation has accumulated earnings and profits, it must maintain separate accounts for previously taxed income (PTI) and the accumulated adjustments account (AAA). If the accumulated E&P was accumulated before the corporation became an S corporation, the corporation may be liable for the tax imposed on excess net passive income, discussed earlier. If a corporation has accumulated E&P, the retained earnings and accumulated E&P usually will not be the same because of the special rules for computation of retained earnings. If the E&P was accumulated after the corporation became an S corporation, the rules in effect before 1983 would apply in figuring accumulated E&P.

Shareholder's treatment of distributions. If an S corporation has earnings and profits but has not elected to distribute them first, discussed later, any distribution it makes will come from one or more of the following sources.

The sources, their order of application, and their tax effect are as follows:

First, a distribution is treated as coming out of the accumulated adjustments account (AAA). A distribution out of AAA is applied against and reduces the shareholder's adjusted basis in the stock. A distribution out of AAA in excess of the shareholder's adjusted basis in the stock is treated as gain from the sale or exchange of property. The AAA is reduced by the amount of the distribution treated as coming from it. If distributions during the tax year exceed the AAA at the close of the tax year (figured before the distributions), the AAA generally is allocated to each distribution made during the year in proportion to the sizes of the distributions.

Second, if the S corporation shareholder has previously taxed income (PTI) in the corporation, the PTI is the next source for distribution. A distribution out of PTI is applied against and reduces the shareholder's basis in the stock. A distribution out of PTI in excess of the shareholder's basis in the stock is treated as gain from the sale or exchange of property. The shareholder's PTI account must be reduced by the amount of the distribution made from PTI.

Third, a distribution is treated as out of the S corporation's earnings and profits. A distribution is treated as a dividend up to the amount of the corporation's earnings and profits.

Fourth, a distribution is applied against and reduces the shareholder's basis in the stock.

Fifth, the distribution is treated as a sale or exchange of property.

Accumulated adjustments account (AAA). The S corporation should maintain an AAA, which is adjusted each year for income, losses, and expenses. The AAA is adjusted in a similar way as the shareholder's basis in the stock of the S corporation, except that no adjustment is made for tax-exempt income or related expenses. However, the amounts of any tax-exempt interest or related expenses are adjustments to the adjusted basis of the stock.

On the first day of an S corporation's first tax year that begins after 1982, the balance of the corporation's AAA is zero. The balance of the corporation's AAA at the end of the tax year can be a negative amount. Income in a later year will make the account positive only after the negative balance has been restored.

Previously taxed income (PTI). The previously taxed income account relates to the rules used for Subchapter S corporations before the Subchapter S Revision Act of 1982 became effective. PTI is personal to a shareholder and cannot be transferred to another shareholder. If the S corporation has earnings and profits, a distribution from PTI is important to a shareholder because an S corporation shareholder who has PTI may receive a nontaxable distribution from PTI. The distribution from PTI comes after a distribution from AAA and before a dividend distribution from earnings and profits.

A distribution of PTI will reduce the shareholder's basis in the S corporation stock and the balance of the shareholder's PTI account.

Example. Cord, an S corporation, has accumulated earnings and profits of $10,000. It distributes $80,000 to its only shareholder, Don. His basis in the stock is $50,000. Cord has $30,000 in its AAA. The order and taxability of the distribution are as follows:

Distribution	Source	Type of Distribution	Taxable or Nontaxable
$80,000			
(30,000)	From AAA	Reduction in basis	Nontaxable
$50,000			
(10,000)	From E&P	Dividend	Taxable
$40,000			
(20,000)	Remaining basis of stock	Reduction in basis	Nontaxable
$20,000			
(20,000)	Excess of basis of stock	Sale or exchange of property	Taxable
–0–			

The corporation reports a $10,000 dividend to the shareholder on Form 1099–DIV, *Statement for Recipients of Dividends and Distributions,* and $70,000 in property distributions on Schedule K–1, *Shareholder's Share of Income, Credits, Deductions, etc.* See the discussion on adjustments to the basis of a shareholder's stock under *Figuring Shareholder Taxable Income,* earlier.

Election to first distribute earnings and profits. For any tax year, an S corporation can elect its distributions as coming first from earnings and profits if all shareholders who receive a distribution during the tax year consent to the election.

The shareholder's consent to the election is effective only for the tax year in which it is made. If the corporation makes an effective election, each shareholder will report a dividend in the amount of the distribution that is treated as coming out of earnings and profits. After the earnings and profits are completely distributed, any future distributions are generally treated as explained earlier under *S Corporation with No Earnings and Profits.*

If the S corporation does not completely distribute earnings and profits in the first tax year it makes the election and wishes to make the same election for the next year, it must repeat the election and again obtain the necessary consents from the shareholders who receive the distributions.

Distributions during a post-termination transition period. Distributions of money during a post-termination transition period by a former S corporation to its shareholders reduces the shareholders' adjusted bases in their stock to the extent of the amount in the accumulated adjustments account (AAA). The former S corporation may elect, with the consent of all its shareholders to whom distributions are made (whether or not they are cash distributions) during this period, to have all distributions of money treated as dividends to the extent of the corporation's earnings and profits. See *S Corporation with Earnings and Profits,* earlier.

The corporation makes this election by attaching to its Form 1120, *U.S. Corporation Income Tax Return,* for the year in which the post-termination transition period ends, a statement that clearly indicates the corporation elects to have section 1371(e)(1) not apply to all distributions made during this period. The statement must be signed by a person authorized to sign the corporation return and by all the shareholders required to consent to the election.

Post-termination transition period. The post-termination transition period begins on the day after the last day of the corporation's last tax year as an S corporation. It ends on the later of the day that is one year after the last day, or the due date for filing the return for the last year as an S corporation, including extensions. In addition, the post-termination transition period is a 120–day period beginning on the date of a determination that the corporation's election of S corporation status had terminated for a previous tax year.

For this purpose, a "determination" means:

1) A court decision that becomes final,
2) A closing agreement, or
3) An agreement between the corporation and the IRS that the corporation did not qualify as an S corporation.

Terminating S Corporation Status

The corporation's status as an S corporation may be terminated in any of the following ways:

- By revoking the election
- By ceasing to qualify as an S corporation
- By violating the passive investment income restrictions on S corporations with pre-S corporations earnings and profits.

Terminations are generally effective on the date of the terminating event. For a termination effective on a day that is not the first day of a tax year, see the discussion under *S Termination Year,* later.

Five-year waiting period. If a corporation's status as an S corporation has been terminated, it generally must wait 5 tax years before it can again become an S corporation. If it gets the permission of the IRS, the waiting period may be less than 5 years.

Revoking S Corporation Status

An S corporation election may be revoked by the corporation for any tax year. It can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation's stock consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

How to revoke. The revocation must be made by the corporation in the form of a statement. The statement must provide:

1) That the corporation is revoking its election to be treated as an S corporation under section 1362(a) of the Internal Revenue Code,
2) The number of shares of stock (including nonvoting stock) outstanding at the time the revocation is made, and
3) The date the revocation is to be effective for revocations that specify a prospective revocation date.

This statement should be signed by someone authorized to sign the S corporation return. It should be sent to the service center where the corporation filed its election to be an S corporation.

To this statement of revocation, the corporation should attach a statement of consent, signed by each shareholder who consents to the revocation. It should also provide the number of shares of outstanding stock (including nonvoting stock) each shareholder holds at the time the revocation is made.

Effective date of revocation. The revocation is effective:

1) On the first day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year.
2) On the first day of the following tax year if the revocation is made after the 15th day of the 3rd month of a tax year.
3) On the date specified if the revocation specifies a date on or after the day the revocation is made.

A corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an S termination year.

See *S Termination Year,* later, for information on filing returns for the S termination year.

Ceasing To Qualify

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. If the corporation inadvertently ceases to qualify, see the later discussion of *Inadvertent terminations.*

Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

- Having more than 35 shareholders,
- Transferring stock in the S corporation to
  - —A corporation,
  - —A partnership,
  - —An ineligible trust, or
  - —A nonresident alien.
- Creating a second class of stock, and
- Acquiring a subsidiary, other than certain nonoperating subsidiaries.

Effective date of termination. A termination of S corporation status will be effective as of the date the terminating event occurred.

A corporation that ceases to be a small business corporation on a date other than the first day of the tax year will create an S termination year. For more information on filing tax returns for the S termination year, see *S Termination Year,* later.

Violating the Passive Income Restriction

A corporation's status as an S corporation will be terminated if both of the following conditions occur for 3 consecutive tax years:

1) It has pre-S corporation earnings and profits at the end of each tax year.
2) Its passive investment income for each tax year is more than 25% of gross receipts. (Passive investment income and gross receipts are figured as explained earlier under *Tax on Excess Net Passive Income.*)

Effective date of termination. A termination of S corporation status because of a violation of the passive income restriction will be effective on the first day of the tax year that follows the third consecutive tax year referred to above. See also *Inadvertent termination,* discussed later.

S Termination Year

Any termination previously described in *Revoking S Corporation Status* and *Violating the Passive Income Restriction* that is effective during the tax year on a date other than the first day of that tax year will create an S termination year. The part of the S termination year ending on the date before the effective date of the termination is an 1120S (S corporation) short tax year. The part of the S termination year beginning on the first day on which the termination is effective is an 1120 (C corporation) short tax year.

After the S termination year is divided into an 1120S short year and an 1120 short year, the separately stated items of income, credit, and deduction, and the amount of the nonseparately stated income or loss must be divided between the periods. There are two methods that can be used to make this division. They are:

1) A pro rata allocation, or
2) An allocation based on normal tax accounting rules.

After the separately stated items and the nonseparately stated income or loss are divided, one set of amounts is used for the 1120S short year and the other set of amounts is used for the 1120 short year.

The corporation will have to file two returns to cover the S termination year. One covers the 1120S short year and one covers the 1120 short year. The S termination year will count only as one tax year for figuring carrybacks and carryforwards, even though two returns are filed for the year.

Pro rata allocation. This method of allocation must be used unless the shareholders and S corporation specifically indicate they choose to use the other allocation method.

The pro rata allocation is made in the following way:

1) Determine for the entire S termination year the amount of each separately stated item of income, loss, deduction, or credit and the amount of the nonseparately stated income or loss.
2) Divide each amount by the number of days in the S termination year.
3) Multiply the amounts from step (2) by the number of days in the Form 1120S short year. These amounts are used for the Form 1120S filed for the 1120S short year.
4) Multiply the amounts from step (2) by the number of days in the 1120 short year. These amounts are used for the Form 1120 filed for the 1120 short year.

The pro rata allocation may not be made if 50% or more of the corporation's stock is sold or exchanged during the S termination year.

Allocation based on normal accounting rules. This is the alternate method of allocation. It can be used if the corporation chooses to use it and all persons who are or were shareholders at any time during the 1120S short year and on the first day of the 1120 short year consent to the choice.

The corporation makes this choice by filing a statement with the return for the 1120 short year, which should include the following:

1) That it chooses to have the *Pro rata allocation rules* not apply.
2) The cause and date of the termination.
3) The signature of the person authorized to sign Form 1120S.
4) A separate statement of consent signed by each person who is, or was, a shareholder at any time during the 1120S short year and on the first day of the 1120 short year.

Under the alternate method of allocation, the corporation will report all items of income, loss, deduction, or credit based on the corporation's books and records (including worksheets). Therefore, the items will be split between the 1120S short year and the 1120 short year according to the time they were realized or incurred based on the corporation's books and records.

The alternate method of allocation must be used by the corporation if there is a sale or exchange of 50% or more of the stock of the corporation during the S termination year.

Return for 1120S short year. Form 1120S for the 1120S short year is due at the same time as Form 1120 is due for the 1120 short year, including extensions.

Return for 1120 short year. To figure the tax on the Form 1120 for the 1120 short year, the taxable income for the 1120 short year must be annualized.

This annualization is done in the following way:

1) Multiply the taxable income of the 1120 short year by the number of days in the S termination year.
2) Divide the amount from step (1) by the number of days in the 1120 short year.
3) Figure the tax on the amount from step (2).
4) Multiply the tax from step (3) by the number of days in the 1120 short year.
5) Divide the amount from step (4) by the number of days in the S termination year.

To figure the corporate alternative minimum tax for the short year, make the following adjustments:

1) The alternative minimum taxable income for the short period is placed on an annual basis by multiplying that amount by 12 and dividing the result by the number of months in the short period, and
2) The tentative minimum tax for the tax year will have the same relation to the tax figured on the annual basis as the number of months in the short period has to 12.

For more information on the alternative minimum tax, see Publication 542, *Tax Information on Corporations.*

Inadvertent Termination

If the corporation is terminated because it inadvertently ceased to qualify as an S corporation or because it inadvertently violated the restriction on passive investment income, the IRS may waive the termination. The termination may be waived if the IRS determines that the termination was inadvertent, the corporation takes steps to correct the event within a reasonable period of time, and the corporation and its shareholders agree to be treated as if the event had not happened.

For example, if a corporation determined in good faith that it had no pre-S corporation earnings and profits, but it was later found on audit that its S corporation status was terminated because the corporation had violated the passive investment income test for 3 consecutive years since there were accumulated earnings and profits, the IRS may find that the terminating event was inadvertent.

The corporation may request a determination in the form of a ruling request whether the termination was inadvertent by following the procedures set out in Revenue Procedure 90–1, 1990–1 C.B. 356. There is a charge of $300 for this ruling.

The request should set forth all relevant facts pertaining to the terminating event, including the date of the corporation's election to be an S corporation, a detailed explanation of the event causing termination, when and how the event was discovered, and the steps taken to return the corporation to small business corporation status.

Such ruling requests should be sent to:

The Internal Revenue Service
Associate Chief Counsel (Technical)
Attention: CC:P&SI
1111 Constitution Avenue, N.W.
Washington, DC 20224

The package should be marked "Ruling Request Submission."

Sample Return

Estex, Inc., is engaged in the distribution of machinery, equipment, and supplies for the building trades It uses an accrual method of accounting and files its returns on the calendar year. In December 1989, Estex, Inc., made a timely and proper election to be treated as an S corporation.

Page 1

When you prepare the corporation's return for 1990, use the pre-addressed label sent to you by the IRS. The pre-addressed label is designed to expedite processing and prevent errors. If you do not have such a label, enter your corporation's name, the street address, room number, suite, or unit, and the city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information at the top of the page, you should report in summary form Estex's items of income and deductions.

The name and employer identification number of the corporation should be shown in the top margin of all schedules and other attachments to Form 1120S.

Line items. All applicable items for income, deductions, and tax listed on page 1 of Form 1120S should be filled in, even though totals may be shown in schedules attached to the return. Do not alter, substitute, or cross out the line captions printed on the official return forms.

Line 1. Gross sales for the year totaled $1,545,700 (line 1a), determined on the accrual method of accounting. After subtracting returned goods and allowances of $21,000 (line 1b), net sales of $1,524,700 are entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $954,700 is the total from Schedule A (line 7) on page 2.

Line 3. Net sales minus cost of goods sold results in gross profit of $570,000.

Line 6. Total income on line 6 is $570,000.

Line 7. The salaries of the company president, vice-presidents, and secretary-treasurer total $170,000 and are included on line 7. Compensation paid to corporate officers must be separated from other salaries and wages and entered on line 7 rather than on line 8.

Line 8. Other salaries and wages are entered on line 8a. The entry includes only salaries and wages not included on line 7 and not deducted as part of cost of goods sold. Salaries and wages of $144,000 on line 8a are reduced by $6,000, the amount of the jobs credit, discussed later, passed through to the shareholders on line 8b.

Line 9. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Estex incurred $800 of repairs.

Line 10. Estex must use the specific charge-off method for bad debts. Actual accounts written off during the year total $1,600.

Line 11. Rental expense for Estex's office and service building was $9,200 for the year.

Line 12. Deductible taxes totaled $15,000.

Line 13. Interest expense accrued during the year amounted to $24,200. This included interest on debts for business operations only. Interest of $850 to carry tax-exempt securities and investments is not included. Interest on the debt to carry investments that produce taxable income is $3,000. It is shown on line 11a of Schedule K and passed through to the shareholders on Schedule K–1.

Lines 14a and 14b. Depreciation of $5,200 is brought forward from Form 4562, *Depreciation and Amortization* (not illustrated). If Estex had a section 179 deduction, it would not be included here. It is reported on Schedule K and is passed through to the shareholders on Schedule K–1.

Line 16. Advertising expense of $8,700 is entered on line 16.

Line 19. Other ordinary and necessary business deductions totaled $78,300. These included miscellaneous office expenses, sales commissions, legal fees, etc. A schedule itemizing these expenses must be attached to the return, even though it is not shown.

Line 20. Total deductions are $451,000.

Line 21. Ordinary income (nonseparately stated income) is $119,000.

Corporate officer's signature. The corporation return must be signed manually by the corporate officer authorized to sign. Use of the corporate seal is optional.

Page 2

Schedule A. Use Schedule A to report the cost of goods sold. This figure is beginning inventory plus merchandise bought or produced during the year minus ending inventory.

Line 1. Because it is a distributor, Estex accounts for its purchasing costs as part of the cost of goods sold. Goods on hand at the beginning of the year were properly valued at $126,000, using the lower of cost or market valuation method. Estex must report this amount on line 1.

Line 2. Purchases cost of $1,127,100 is listed on line 2.

Line 6. Estex had goods on hand at the end of the year properly valued at $298,400. Estex must report that amount on line 6.

Lines 8a — 8e. All applicable items and questions on these lines should be completed.

Additional information. All applicable items and questions in this section should be completed.

Designation of tax matters person. The identification information relating to the shareholder designated as the tax matters person should be provided as indicated at the bottom of page 2, Form 1120S.

Page 3

Schedule K. Schedule K summarizes the corporation's income, deductions, credits, etc., that are reportable by the shareholders.

Line 1. On line 1, Estex shows the ordinary income (nonseparately stated income) of $119,000 from line 21, page 1.

Line 4. Line 4 is used to report portfolio income and loss items. Portfolio items include interest income, dividend income, royalty income, short-term capital gain or loss, and long-term capital gain or loss. Estex had the following portfolio items:

1) Taxable interest income of $4,000 reportable on ***line 4a,*** and
2) Taxable dividends of $16,000 reportable on ***line 4b.***

Line 7. Line 7 is for charitable contributions. During 1990, Estex contributed $11,400 to the United Community Fund and $12,600 to the State University Scholarship Fund. The total of $24,000, subject to a 50% limitation, is entered in the total column on line 7.

Lines 11a and 11b. These lines show the items that must be taken into account by shareholders to figure their interest deduction on investment indebtedness. ***Line 11a*** is used for investment interest expense. Estex had investment interest of $3,000. ***Line 11b(1)*** is for investment income. Estex had taxable interest from investments (line 4a) totaling $4,000. Estex also had dividends from investments (line 4b) totaling $16,000. Therefore, Estex must enter $20,000 on line 11b(1). Each shareholder's share of these items must be reported on Schedule K–1.

Line 13. Line 13 is for the jobs credit. Estex had $6,000 of jobs credit in 1990. The credit was figured on Form 5884, *Jobs Credit,* (not shown here).

Line 17. Line 17 is for distributions other than those reported on line 19. Estex distributed $65,000 in 1990.

Line 18. Line 18 is for other adjustments that would affect shareholders' bases in their S corporation stock. In 1990, Estex earned $5,000 of tax-exempt interest from state bonds, and had $6,000 of nondeductible salaries and wages due to the jobs credit. A separate schedule of the amounts (not shown here) is attached to the return.

Line 20. Taxable income of $112,000 from line 8, Schedule M–1, is entered here.

Schedule K–1. A separate Schedule K–1 is completed by the S corporation for each shareholder.

Generally, shareholders must treat items of income, loss, deduction, credit, etc., on their returns consistent with the way the S corporation reported them on its return. A shareholder who reports the items differently from the way the S corporation reported them on Schedule K–1 should complete Form 8082, *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)).*

A copy of each shareholder's Schedule K–1 should be filed with Form 1120S. A copy is kept as a part of the corporation's records, and each shareholder receives a copy with instructions attached.

Estex must prepare a Schedule K–1 for each shareholder. The illustrated Schedule K–1 is for John H. Anders who owns 9,000 shares (45%) of the corporation's stock, which he acquired on March 3, 1973. He devotes 100% of his time to the business for which he is paid $40,000.

Lines 1 through 10 are for each shareholder's distributive share of nonseparately stated income or loss and separately stated income or loss and deductions.

Line 1. Line 1 shows Mr. Anders' share of nonseparately stated income of $53,550. It makes no difference whether this income was distributed to him in 1990. He must report $53,550 on Schedule E (Form 1040) when he files his individual income tax return, Form 1040.

Line 4. Line 4 is for portfolio income and loss items. Mr. Anders' share of interest income is $1,800. His share of dividend income is $7,200.

Line 7. Line 7 is for Mr. Anders' share of Estex's charitable contributions for 1990. His share is $10,800. Because all of Estex's contributions were given to public charities, they qualify for the 50% limitation.

Lines 11a and 11b. These lines are used to show each shareholder's share of interest on investment indebtedness. The amounts reported on these lines will be used to complete Form 4952, *Investment Interest Expense Deduction.*

Line 11a shows Mr. Anders' share of Estex's investment interest expense, $1,350 (45% × $3,000). Investment interest expense is that part of Estex's total interest for loans made to carry its investment. ***Line 11b(1)*** shows Mr. Anders' share of Estex's investment income, $9,000 (45% × $20,000). This represents Estex's income from ordinary dividends and interest. It does not include interest on municipal bond investments, which is tax-exempt.

Line 13. Line 13 is for the jobs credit. Mr. Anders' share of Estex's jobs credit is $2,700 (45% × $6,000).

Line 17. Line 17 is for distributions paid during the year other than those paid from accumulated earnings and profits and reported on Form 1099–DIV. During 1990, Estex distributed $65,000. Mr. Anders' 45% share of the distribution was $29,250.

Line 21. Line 21 is for supplemental information and other items that would affect a shareholder's basis in S corporation stock, such as nontaxable income, nondeductible expenses, and income and expenses from oil and gas property used to figure shareholders' depletion, etc. In 1990, Estex had $5,000 of tax-exempt interest from state bonds and $6,000 of nondeductible salaries and wages due to the jobs credit. Mr. Anders' 45% share of the tax-exempt interest and the nondeductible salaries and wages was $2,250 and $2,700, respectively. These amounts are shown here.

Page 4

Schedule L. Comparative balance sheets for the beginning and end of the tax year must be shown on Schedule L. Entries on this schedule should agree with amounts shown on the corporation's books and records. For example, the figures for beginning and ending inventories must be the same as those appearing in the analysis of cost of goods sold. In addition, the figures on the balance sheet for the beginning of the tax year will normally agree with the balance sheet figures for the end of the last tax year.

Schedules M–1 and M–2. These schedules must be completed if the total assets (line 15, column (d), Schedule L) are $25,000 or more. To properly complete these schedules, you must first get additional information from your corporation's books and records.

The following appeared on the books of Estex for the calendar year 1990.

Account	Debit	Credit
Gross sales		$1,545,700
Sales returns and allowances	$ 21,000	
Cost of goods sold	954,700	
Dividend income		16,000
Interest income (on state bonds)		5,000
(other—taxable)		4,000
Premiums on life insurance	9,500	
Compensation of officers	170,000	
Salaries and wages	144,000	
Repairs	800	
Bad debts	1,600	
Rental expense	9,200	
Taxes	15,000	
Interest expense (on loan to buy tax-exempt bonds)	$ 850	
(other)	27,200	28,050
Contributions		24,000
Depreciation		3,580
Advertising		8,700
Other expenses of operation		78,300
Net income per books		102,270
Total		$1,570,700 $1,570,700

Schedule M–1. Schedule M–1 starts with the net income per books as shown in the corporation's books and records. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 20, Schedule K.

Line 1. This is the net income per books, $102,270, shown on the corporation's books.

Line 2. This should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued on the corporate books at an amount greater than that used for tax purposes. When a sale of such assets is made, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

Line 3. This is for expenses recorded on the corporation's books that may not be deducted. They are shown in an itemized statement attached to the return, which is not illustrated. It would include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Reduction of salaries by jobs credit	6,000
Total	$16,350

Line 4. This is the total of lines 1 through 3.

Line 5. This shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals $5,000, the interest on state bonds.

Line 6. This includes all deductions claimed for tax purposes that are not recorded on the corporation's books. Estex enters $1, 620 on line 6a. This represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

Line 7. This shows the total of lines 5 and 6, or $6,620.

Line 8. The difference, $112,000, between lines 4 and 7 must agree with line 20, Schedule K.

Schedule M–2, Schedule M–2 provides an analysis of certain earned equity accounts of the corporation for the tax year. The schedule shows the changes to the equity accounts for the income, deductions, distributions, etc., that are reported on the return for the tax year.

Column (a), Line 1. The first column is the accumulated adjustments account. For an S corporation's first year beginning after 1982, the initial balance in the account is zero. Estex enters zero on line 1.

Line 2. Estex's ordinary income for 1990 (page 1, line 21) is $119,000. This is entered on line 2.

Line 3. Estex enters $20,000 ($16,000 dividends plus $4,000 interest) on line 3. This is made up of amounts on lines 4a and 4b of Schedule K.

Line 4. Line 4 is for any loss shown on page 1, line 21. Because Estex has no losses in 1990, line 4 is zero.

Line 5. Estex enters $33,000. This is made up of $3,000 interest on a loan to carry investments, $6,000 reduction in salaries and wages due to the jobs credit, and $24,000 charitable contributions.

Line 6. Line 6 is the total of lines 1 through 5, or $106,000.

Line 7. Line 7 is for distributions other than dividend distribution. Estex enters $65,000 on this line.

Line 8. Line 8 shows the balance in the accumulated adjustments account at the end of the year. Estex subtracts line 7 from line 6 and enters $41,000 here.

Column (b), Line 1. The second column is the other adjustments account. It is for other items, such as tax-exempt income and related expenses. For 1990, the balance at the beginning of the year is zero.

Line 3. Estex had $5,000 of tax-free interest income from state bonds. This amount is entered on line 3.

Line 6. The total of lines 1 through 5, $5,000, is entered on line 6.

Line 7. Because the total distributions, other than dividends, did not exceed the balance in the accumulated adjustments account, none of the distribution is applied to the other adjustments account. Estex enters zero on line 7.

Line 8. The balance in the other adjustments account at the end of the year is $5,000. Estex enters this amount here.

Column (c). The third column is for undistributed taxable income that was included in shareholders' income for years that began before 1990. Since this is Estex's first year as an S corporation, there are no entries in this column.

Form **1120S**
Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

For calendar year 1990, or tax year beginning _____, 1990, and ending _____, 19___.
▶ See separate instructions.

OMB No. 1545-0130

1990

A Date of election as an S corporation: 12-1-89

B Business code no. (see Specific Instructions): 5008

Use IRS label. Otherwise, please print or type.

10-4487965 DEC90 D74 3070
ESTEX, INC.
482 WINSTON STREET
METRO CITY OH 43705

IRS

C Employer identification number: 10-4487965

D Date incorporated: 3-1-72

E Total assets (see Specific Instructions): $ 825,714

F Check applicable boxes: (1) ☑ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

G Check this box if this is an S corporation subject to the consolidated audit procedures of sections 6241 through 6245 (see instructions before checking this box) . . ▶ ☐

H Enter number of shareholders in the corporation at end of the tax year . . . . . ▶ 6

Caution: *Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income	1a	Gross receipts or sales: 1,545,700	b Less returns and allowances: 21,000	c Bal ▶	1c	1,524,700
	2	Cost of goods sold (Schedule A, line 7)			2	954,700
	3	Gross profit (subtract line 2 from line 1c)			3	570,000
	4	Net gain (loss) from Form 4797, Part II, line 18			4	-0-
	5	Other income (see instructions) *(attach schedule)*			5	-0-
	6	**Total** income (loss)—Combine lines 3 through 5		▶	6	570,000
Deductions (See instructions for limitations.)	7	Compensation of officers			7	170,000
	8a	Salaries and wages: 144,000	b Less jobs credit: 6,000	c Bal ▶	8c	138,000
	9	Repairs			9	800
	10	Bad debts			10	1,600
	11	Rents			11	9,200
	12	Taxes			12	15,000
	13	Interest			13	24,200
	14a	Depreciation (see instructions): 5,200				
	b	Depreciation reported on Schedule A and elsewhere on return: -0-				
	c	Subtract line 14b from line 14a			14c	5,200
	15	Depletion (**Do not deduct oil and gas depletion.** See instructions.)			15	-0-
	16	Advertising			16	8,700
	17	Pension, profit-sharing, etc., plans			17	-0-
	18	Employee benefit programs			18	-0-
	19	Other deductions *(attach schedule)*			19	78,300
	20	**Total** deductions—Add lines 7 through 19		▶	20	451,000
	21	Ordinary income (loss) from trade or business activities—Subtract line 20 from line 6			21	119,000
Tax and Payments	22	**Tax:**				
	a	Excess net passive income tax *(attach schedule)*: 22a				
	b	Tax from Schedule D (Form 1120S): 22b				
	c	Add lines 22a and 22b (see instructions for additional taxes)			22c	-0-
	23	**Payments:**				
	a	1990 estimated tax payments: 23a				
	b	Tax deposited with Form 7004: 23b				
	c	Credit for Federal tax on fuels *(attach Form 4136)*: 23c				
	d	Add lines 23a through 23c			23d	-0-
	24	Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached			24	-0-
	25	**Tax due**—If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See instructions for depositary method of payment		▶	25	-0-
	26	**Overpayment**—If line 23d is larger than the total of lines 22c and 24, enter amount overpaid		▶	26	-0-
	27	Enter amount of line 26 you want: **Credited to 1991 estimated tax** ▶	**Refunded** ▶		27	-0-

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

John H. Anders — Signature of officer
3-10-91 — Date
President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Schedule A Cost of Goods Sold (See instructions.)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	-0-
4a	Additional section 263A costs (see instructions) *(attach schedule)*	4a	-0-
b	Other costs *(attach schedule)*	4b	-0-
5	Total—Add lines 1 through 4b	5	1,253,100
6	Inventory at end of year	6	298,400
7	Cost of goods sold—Subtract line 6 from line 5. Enter here and on line 2, page 1	7	954,700

8a Check all methods used for valuing closing inventory:
- (i) ☐ Cost
- (ii) ☑ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)
- (iv) ☐ Other (specify method used and attach explanation) ▶

b Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 8c

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☐ Yes ☑ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☑ No
If "Yes," attach explanation.

Additional Information Required (continued from page 1)

		Yes	No
I	Did you at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? For rules of attribution, see section 267(c). If "Yes," attach a schedule showing: **(1)** name, address, and employer identification number; and **(2)** percentage owned.		✓
J	Refer to the list in the instructions and state your principal: (1) Business activity ▶ 5008 - Distributor (2) Product or service ▶ Heavy Equipment		
K	Were you a member of a controlled group subject to the provisions of section 1561?		✓
L	At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See instructions for exceptions and filing requirements for form TD F 90-22.1.)		✓
	If "Yes," enter the name of the foreign country ▶		
M	Were you the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		✓
N	During this tax year did you maintain any part of your accounting/tax records on a computerized system?		✓
O	Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶		
P	Check this box if the S corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐		
Q	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
R	If the corporation: **(1)** filed its election to be an S corporation after 1986, **(2)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and **(3)** has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ $ 37,200		
S	Check this box if the corporation had subchapter C earnings and profits at the close of the tax year (see instructions) ▶ ☑		

Designation of Tax Matters Person (See instructions.)

Enter below the shareholder designated as the tax matters person (TMP) for the tax year of this return:

Name of designated TMP ▶ John H. Anders

Identifying number of TMP ▶ 458-00-0327

Address of designated TMP ▶ 4340 Holmes Parkway, Metro City, OH 43704

Schedule K Shareholders' Shares of Income, Credits, Deductions, Etc.

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	119,000
	2	Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a	Gross income from other rental activities 3a		
	b	Less expenses *(attach schedule)* 3b		
	c	Net income (loss) from other rental activities	3c	
	4	Portfolio income (loss):		
	a	Interest income	4a	4,000
	b	Dividend income	4b	16,000
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4d	
	e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4e	
	f	Other portfolio income (loss) *(attach schedule)*	4f	
	5	Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*	5	
	6	Other income (loss) *(attach schedule)*	6	
Deductions	7	Charitable contributions (see instructions) *(attach list)*	7	24,000
	8	Section 179 expense deduction *(attach Form 4562)*	8	
	9	Deductions related to portfolio income (loss) (see instructions) (itemize)	9	
	10	Other deductions *(attach schedule)*	10	
Investment Interest	11a	Interest expense on investment debts	11a	3,000
	b	(1) Investment income included on lines 4a through 4f above	11b(1)	20,000
		(2) Investment expenses included on line 9 above	11b(2)	
Credits	12a	Credit for alcohol used as a fuel *(attach Form 6478)*	12a	
	b	Low-income housing credit (see instructions):		
		(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
		(2) Other than on line 12b(1) for property placed in service before 1990	12b(2)	
		(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
		(4) Other than on line 12b(3) for property placed in service after 1989	12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)	12d	
	e	Credits related to other rental activities (see instructions)	12e	
	13	Other credits (see instructions) Jobs Credit	13	6,000
Adjustments and Tax Preference Items	14a	Accelerated depreciation of real property placed in service before 1987	14a	
	b	Accelerated depreciation of leased personal property placed in service before 1987	14b	
	c	Depreciation adjustment on property placed in service after 1986	14c	
	d	Depletion (other than oil and gas)	14d	
	e	(1) Gross income from oil, gas, or geothermal properties	14e(1)	
		(2) Deductions allocable to oil, gas, or geothermal properties	14e(2)	
	f	Other adjustments and tax preference items *(attach schedule)*	14f	
Foreign Taxes	15a	Type of income ▶		
	b	Name of foreign country or U.S. possession ▶		
	c	Total gross income from sources outside the U.S. *(attach schedule)*	15c	
	d	Total applicable deductions and losses *(attach schedule)*	15d	
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e	
	f	Reduction in taxes available for credit *(attach schedule)*	15f	
	g	Other foreign tax information *(attach schedule)*	15g	
Other Items	16a	Total expenditures to which a section 59(e) election may apply	16a	
	b	Type of expenditures ▶		
	17	Total property distributions (including cash) other than dividends reported on line 19 below	17	65,000
	18	Other items and amounts required to be reported separately to shareholders (see instructions) *(attach schedule)*		
	19	Total dividend distributions paid from accumulated earnings and profits	19	
	20	Income (loss) (Required only if Schedule M-1 must be completed.)—Combine lines 1 through 6 in column (b). From the result subtract the sum of lines 7 through 11a, 15e, and 16a	20	112,000

SCHEDULE K-1 (Form 1120S)
Department of the Treasury Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, Etc.

► See separate instructions.
For calendar year 1990 or tax year beginning , 1990, and ending , 19

OMB No. 1545-0130

1990

Shareholder's identifying number ► 458-00-0327

Shareholder's name, address, and ZIP code
John H. Anders
4340 Holmes Parkway
Metro City, OH 43704

Corporation's identifying number ► 10-4487965

Corporation's name, address, and ZIP code
Estex, Inc.
482 Winston Street
Metro City, OH 43705

A Shareholder's percentage of stock ownership for tax year (see Instructions for Schedule K-1) ► 45 %

B Internal Revenue Service Center where corporation filed its return ► Cincinnati, OH

C (1) Tax shelter registration number (see Instructions for Schedule K-1) ►
(2) Type of tax shelter ►

D If the shareholder acquired corporate stock after 10/22/86, check here ► ☐ and enter the shareholder's weighted percentage increase in stock ownership for 1990 (see Instructions for Schedule K-1) ► %

E If any activity for which income or loss is reported on line 1, 2, or 3, was started or acquired by the corporation after 10/22/86, check here ► ☐ and enter the date of start up or acquisition in the date space on line 1, 2, or 3 below.

F Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities. If applicable, enter date asked for in item E ►	1	53,550	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	2 Net income (loss) from rental real estate activities. If applicable, enter date asked for in item E ►	2		
	3 Net income (loss) from other rental activities. If applicable, enter date asked for in item E ►	3		
	4 Portfolio income (loss):			
	a Interest	4a	1,800	Sch. B, Part I, line 1
	b Dividends	4b	7,200	Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e Net long-term capital gain (loss)	4e		Sch. D, line 12, col. (f) or (g)
	f Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5 Net gain (loss) under section 1231 (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	6 Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return.)
Deductions	7 Charitable contributions	7	10,800	Sch. A, line 14 or 15
	8 Section 179 expense deduction *(attach schedule)*	8		
	9 Deductions related to portfolio income (loss) *(attach schedule)*	9		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	10 Other deductions *(attach schedule)*	10		
Investment Interest	11a Interest expense on investment debts	11a	1,350	Form 4952, line 1
	b (1) Investment income included on lines 4a through 4f above	b(1)	9,000	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	(2) Investment expenses included on line 9 above	b(2)		
Credits	12a Credit for alcohol used as fuel	12a		Form 6478, line 10
	b Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
	(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities (see instructions)	12c		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)	12d		
	e Credits related to other rental activities (see instructions)	12e		
	13 Other credits (see instructions) Jobs Credit	13	2,700	

	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Adjustments and Tax Preference Items	14a Accelerated depreciation of real property placed in service before 1987	14a		See Shareholder's Instructions for Schedule K-1 (Form 1120S) and Form 6251 Instructions.
	b Accelerated depreciation of leased personal property placed in service before 1987	14b		
	c Depreciation adjustment on property placed in service after 1986	14c		
	d Depletion (other than oil and gas)	14d		
	e (1) Gross income from oil, gas, or geothermal properties	e(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	e(2)		
	f Other adjustments and tax preference items *(attach schedule)*	14f		
Foreign Taxes	15a Type of income ►			Form 1116, Check boxes
	b Name of foreign country or U.S. possession ►			Form 1116, Part I
	c Total gross income from sources outside the U.S. *(attach schedule)*	15c		Form 1116, Part I
	d Total applicable deductions and losses *(attach schedule)*	15d		Form 1116, Part I
	e Total foreign taxes (check one): ► ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g Other foreign tax information *(attach schedule)*	15g		See Form 1116 Instructions
Other Items	16a Total expenditures to which a section 59(e) election may apply	16a		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	b Type of expenditures ►			
	17 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	17	29,250	
	18 Amount of loan repayments for "Loans from Shareholders"	18		
Recapture of Tax Credits	19 Recapture of low-income housing credit:			Form 8611, line 8
	a From section 42(j)(5) partnerships	19a		
	b Other than on line 19a	19b		

20 Investment credit properties:

	A	B	C	
a Description of property (State whether recovery or non-recovery property. If recovery property, state whether regular percentage method or section 48(q) election is used.)				Form 4255, top
b Date placed in service				Form 4255, line 2
c Cost or other basis				Form 4255, line 3
d Class of recovery property or original estimated useful life				Form 4255, line 4
e Date item ceased to be investment credit property				Form 4255, line 8

Supplemental Information

21 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*:

Tax-Exempt Interest $ 2,250

Nondeductible Salaries & Wages Due To Jobs Credit $ 2,700

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Schedule L Balance Sheets

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		14,700		14,514
2a Trade notes and accounts receivable	98,400		33,700	
b Less allowance for bad debts		98,400		33,700
3 Inventories		126,000		298,400
4 U.S. government obligations				
5 Tax-exempt securities		100,000		120,000
6 Other current assets *(attach schedule)*		26,300		26,300
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments *(attach schedule)*		100,000		100,000
10a Buildings and other depreciable assets	204,700		198,700	
b Less accumulated depreciation	6,000	198,700	5,200	193,500
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets *(attach schedule)*		14,800		19,300
15 Total assets		698,900		825,714
Liabilities and Shareholders' Equity				
16 Accounts payable		28,500		34,834
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities *(attach schedule)*		6,800		7,400
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		191,300		265,180
21 Other liabilities *(attach schedule)*				
22 Capital stock		200,000		200,000
23 Paid-in or capital surplus				
24 Retained earnings		268,000		314,000
25 Less cost of treasury stock		( )		( )
26 Total liabilities and shareholders' equity		698,900		825,714

Schedule M-1 Reconciliation of Income per Books With Income per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books	102,270	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize): a Tax-exempt interest $ 5,000	5,000
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):	-0-		
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16a (itemize): a Depreciation $ b Travel and entertainment $	16,350	6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16a, not charged against book income this year (itemize): a Depreciation $ 1,620	1,620
		7 Total of lines 5 and 6	6,620
4 Total of lines 1 through 3	118,620	8 Income (loss) (Schedule K, line 20)—Line 4 less line 7	112,000

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (See instructions.)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	-0-	-0-	
2 Ordinary income from page 1, line 21	119,000		
3 Other additions	20,000	5,000	
4 Loss from page 1, line 21	(-0-)		
5 Other reductions	(33,000)	(-0-)	
6 Combine lines 1 through 5	106,000	5,000	
7 Distributions other than dividend distributions	65,000	-0-	
8 Balance at end of tax year—subtract line 7 from line 6	41,000	5,000	

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General Guides

1 ..... Your Rights as a Taxpayer
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225 ..... Farmer's Tax Guide
334 ..... Tax Guide for Small Business
509 ..... Tax Calendars for 1991
553 ..... Highlights of 1990 Tax Changes
595 ..... Tax Guide for Commercial Fishermen
910 ..... Guide to Free Tax Services

Employer's Guides

15 ..... Employer's Tax Guide (Circular E)
51 ..... Agricultural Employer's Tax Guide (Circular A)
80 ..... Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

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463 ..... Travel, Entertainment, and Gift Expenses
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